Position Paper on Improving the SFDR

Proposal for financial product categories from a sustainability perspective

This position paper was produced in cooperation between the Sustainable Finance Research Group at the University of Hamburg represented by Prof. Timo Busch, Advanced Impact Research (AIR) and F.I.R.S.T e.V.. It has been nourished by the review- and assessment works that have been done for several hundreds of investment funds regularly applying for the SRI quality standard FNG-Label.
It proposes categories for financial products from a sustainability perspective in the context of the current targeted consultation of the Sustainable Finance Disclosure Regulation (SFDR). The goal is to find a balance between clear terminology, consistency between existing sustainable finance regulations, clarity of proposed categories for investors and minimum effort for transitioning to the new categories.

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Introduction

The uptake of SFDR's Article 8 and 9 as labels for financial products showed a clear market need for such tools. The framework of Article 8 and 9 developed in the Sustainable Finance Disclosure Regulation (SFDR) is, however, not constructed for that purpose. We argue that Article 8 and 9 should be developed into full-fledged categories for financial products that are conceptually clear and easy to understand for both retail and institutional investors. This position paper proposes product categories that build upon existing regulatory concepts and provides additions and specifications where necessary to clearly focus on the transition to a sustainable economy. Based on this, we also propose some changes to SFDR level 1 and the definition of sustainability preferences in the Markets in Financial Instruments Directive (MiFID) II and the Insurance Distribution Directive (IDD).

Financial product categories

We propose three different categories for financial products from a sustainability perspective: (1) **Transition products**, (2) **sustainability focused products**[1] and (3) **ESG products**. Transition and sustainability focused products can be collectively referred to as impact products (see table 1). All of the categories are defined based on three dimensions: (1) The objective, (2) the investment strategy and (3) the measurement of sustainability performance. Transition and sustainability focused products are together referred to as impact products because both aim to contribute positively to sustainability objectives, either on the asset or the investor level.

Sustainability objective

To be categorized as transition or sustainability focused, financial products need a sustainability objective as part of their investment objective. Financial products need to commit to one of the following objectives to classify as **transition products**:

(1) The objective to make transition investments[2] (without investor contribution).
(2) The objective to contribute to assets' transition (with investor contribution).

Similarly, financial products need to commit to one of the following objectives to classify as **sustainability focused products**:

(3) The objective to make sustainable investments (without investor contribution).
(4) The objective to contribute to assets' sustainable performance as an investor (with investor contribution).

Managing ESG risks and opportunities as an objective

Financial products with the objective to manage assets' ESG risks and opportunities to optimize the portfolio's risk and return profile should be classified as **ESG products**. They do not qualify

[1] This is referring to the similarly named category of the UK's Financial Conduct Authority (FCA), to increase comparability between different regulatory regimes where possible (FCA 2023, p. 98)
[2] For a concrete definition of this and other terms, see section "Key concepts".

as transition or sustainability focused products, as long as they do not also commit to one of the sustainability objectives necessary for these categories and measure the underlying assets' transition or sustainability performance.

Investment strategy

To be considered a **transition product**, financial products need to invest at least **70 percent** of their portfolio in transition investments. This can be implemented using different negative and positive screening strategies[3]. In case a transition product aims to have investor contribution, it also needs to implement stewardship approaches or provide new capital to positively contribute to the assets' transition towards a sustainable level of performance.

To be considered a **sustainability focused product**, financial products need to invest at least **70 percent** of their portfolio in sustainable investments. This can be implemented using different negative and positive screening strategies. In case a sustainability focused product aims to have investor contribution, it also needs to implement stewardship approaches or to provide new capital to positively contribute to safeguard or increase the assets' sustainable level of performance.

Financial products can also aim to do both transition and sustainable investments. In this case, they need to invest at least **70 percent** of their portfolio in a mixture of transition and sustainable investments. The financial product is then categorized based on the share of investments that is larger (transition or sustainable investments). If at some point in time the share of transition and sustainable investments is the same, the product should be categorized so as to retain the previous category, so that the product classification is as coherent as possible over time.[4]

ESG products use positive or negative screening to manage the ESG risks and opportunities of the assets in their portfolio. This type of risk management is often considered a part of fiduciary duties. Also, the EU already updated regulations and directives on UCITs[5] and AIFs[6] to take into account sustainability risks.

Measurement of sustainability performance

To classify as a **transition product**, financial products need to provide evidence that the assets they invest in have a credible, ideally science-based and verified transition plan that specifies targets to achieve sustainable performance levels based on concrete KPIs. They also need a system to monitor the compliance to those targets. In case a transition product aims to have

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[3] We use the definition of screening as recently proposed by the Global Sustainable Investment Alliance (GSIA): "Applying rules based on defined criteria that determine whether an investment is permissible. " (GSIA 2023, p. 3).

[4] For both transition and sustainability focused products, there could be limited exceptions to the 70 percent threshold as, for example, described in the FCA's disclosure regime. They, for example, refer to exceptions to the 70 percent threshold "where products are designed to build their initial portfolio over time and therefore have yet to fully invest in assets" (FCA 2023, p. 100).

[5] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021L1270

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R1255

investor contribution, it needs to provide evidence that its investor activities (stewardship or new capital) contributed positively to the assets' transition. If the transition plan is not fulfilled, the financial product should use escalation strategies to incentivize asset's transition as effectively as possible[7].

To classify as a **sustainability focused product**, financial products need to provide evidence that the assets they invest in have a sustainable level of performance based on concrete KPIs. In case a sustainability focused product aims to have investor contribution, it needs to provide evidence that their investor activities (stewardship or new capital) contributed positively to the assets' sustainable performance (safeguarding the performance to stay sustainable or improving the sustainable performance further).

Portfolio shares based on investor contribution

Besides the threshold of 70 percent on portfolio level, a classification scheme for financial products needs to distinguish portfolio shares based on whether investor contribution is aimed for and was achieved or not. This is important to reduce impact-washing, as argued by the European Securities and Markets Authority (ESMA)[8]. Accordingly, the share of transition or sustainable investments in a portfolio should be distinguished based on the planned and realized investor contribution, depending on the phase of the investment process.

Without investor contribution to the transition of assets, the portfolio's share of transition investments is considered to be **impact-aligned** (in the sense that the portfolio is invested in assets that transition, i.e. have a positive impact). The part of transition investments in the portfolio where the financial product contributes to the asset's transition is considered **impact-generating** (in the sense that the financial product supports the transition of the underlying assets). The 70 percent threshold can consist of both impact-aligned or impact-generating portfolio shares without minimum thresholds for either of them. But the impact-aligned and impact-generating shares of the portfolio need to be reported publicly both in pre-contractual and periodic reporting.

Without investor contribution to the sustainable performance of assets, the portfolio share of sustainable investments is **impact-aligned** (in the sense that the portfolio is invested in assets that already have a positive impact through their sustainable level of performance). In case the sustainability focused product contributes to the assets sustainable performance, the portfolio share of sustainable investments is considered **impact-generating** (in the sense that the financial product supports maintaining or improving the already sustainable performance of the underlying assets). The 70 percent threshold can consist of both impact-aligned or impact-generating portfolio shares without minimum thresholds for either of them. But the impact-

[7] For an explanation on which parts of an asset's value chain transition and sustainability focused products should focus on, see section "key concepts" and the definitions of transition and sustainable investments provided there.
[8] https://www.esma.europa.eu/sites/default/files/2023-06/ESMA30-1668416927-2498_Progress_Report_ESMA_response_to_COM_RfI_on_greenwashing_risks.pdf (p. 40-42)

aligned or impact-generating shares of the portfolio need to be reported publicly both in pre-contractual and periodic reporting.

As a result, for both transition and sustainability focused products, the investor contribution is specified using the wording impact-aligned and impact-generating. This is due to the fact that the investor contribution always focuses on whether the investor supports or induces a change, i.e. an impact, in the asset's sustainability performance. In most cases, even assets already performing sustainably will need to sustain this level of performance over time. In other cases, already sustainable assets might still have room for improving their performance even further. In both instances, the investor can support the assets in maintaining or improving their already sustainable performance. This is why impact-aligned and impact-generating are also applied to sustainability focused products. This also helps to explain different portfolio compositions in different types of impact products to investors.

Table 1: Proposed classification scheme for financial products

		Impact Products			
Product Category	**ESG Products**	**Transition Products**		**Sustainability Focused Products**	
Objective	Managing assets' ESG risks & opportunities to optimize risk & return profile	Invest in transition investments	Contribute to assets' transition as an investor	Invest in sustainable investments (SFDR/EU-Taxonomy)	Contribute to assets' sustainable performance as an investor
Investment Strategy	Positive or Negative Screening	Positive & Negative Screening	New Capital (Positive & Negative Screening) or Stewardship	Positive & Negative Screening	New Capital (Positive & Negative Screening) or Stewardship
Measurement Sustainability Performance		Evidence of assets' transition	Evidence of assets' transition & investor contribution	Evidence of assets' sustainable performance	Evidence of assets' sustainable performance & investor contribution
Investor Contribution	-	Impact-aligned	Impact-generating	Impact-aligned	Impact-generating
Portfolio Level Threshold	-	70% transition investments		70% sustainable investments	

Key concepts

The proposed categories for financial products build as much as possible on definitions established by existing EU sustainable finance regulation. Since these concepts where not developed with the goal to provide clear sustainability-related product categories, some existing terms need to be specified and some new terms need to be introduced. We only propose changes where current regulatory terminology is not fit for providing a classification scheme for financial products to make the transition from existing SFDR requirements to the new scheme as easy as possible for practitioners. There are key concepts on both asset and portfolio level.

Asset level

Positive contribution to a sustainability objective

The most important starting point is the concept of a **positive contribution to a sustainability objective** defined both in the SFDR in Article 2(17)[9] when defining sustainable investments and in the EU Taxonomy Regulation in Article 2(1)[10] when defining environmentally sustainable investments. The EU Platform on Sustainable Finance (PSF) provided some insights into how this understanding of positive contribution can be differentiated between different **levels of performance** (substantial contribution, intermediate performance, significant harm)[11].

Another, likely less well-known definition of contribution is provided in the European Sustainability Reporting Standards (ESRS) Annex 2, which defines impacts as:

> "The effect the undertaking has or could have on the environment and people, including effects on their human rights, connected with its own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships. The impacts can be actual or potential, negative or positive, intended or unintended, and reversible or irreversible. They can arise over the short-, medium-, or long-term. **Impacts indicate the undertaking's contribution**, negative or positive, to sustainable development."[12] (emphasis added by the authors)

Social or environmental impacts or effects entail a **change in the performance** of a specific social or environmental indicator.[13] As a result, current sustainable finance regulation uses two different understandings of contribution towards a sustainability objective on asset level:

(1) Contribution as a sustainable ***level of social or environmental performance*** (SFDR, EU Taxonomy, EU PSF).

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[9] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02019R2088-20200712
[10] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852&qid=1702038862056
[11] https://finance.ec.europa.eu/system/files/2022-03/220329-sustainable-finance-platform-finance-report-environmental-transition-taxonomy_en.pdf (p. 49)
[12] https://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303-annex-2_en.pdf (p. 16)
[13] See, for example, Kölbel et al.'s definition of impact as "***change*** *in a specific social or environmental parameter that is caused by an activity*" (https://journals.sagepub.com/doi/epub/10.1177/1086026620919202). (emphasis added by the authors).

(2) Contribution as a ***change in social or environmental performance*** due to undertakings' activities towards a sustainable level of performance (**transition or impact**).[14]

This differentiation is essential in clearly distinguishing the proposed categories. Not making this distinction explicit leads to confusion and unclarity in the market. To define what level of social or environmental performance can be considered sustainable with reference to a sustainability objective, measurement should refer to societal or ecological thresholds wherever feasible (see Table 3 and 4 below). The Impact Management Platform (IMP)[15] defines societal or ecological thresholds as "A level or range of performance that divides sustainable from unsustainable performance. These ranges are set with reference to social norms or planetary limits that have been identified through scientific research."[16][17] Using thresholds to define sustainable levels of performance is already practiced in the definition of environmentally sustainable investments in the EU taxonomy which establishes thresholds for substantial contribution and thresholds for doing no significant harm. This approach was further specified by the EU Platform on Sustainable Finance.[18] Also, assessing DNSH for sustainable investments as defined in SFDR based on principal adverse impact indicators (PAIs) entails using thresholds in many cases. In current practice of DNSH assessments, many financial market participants determine their own thresholds to define the level of performance that is considered significantly harmful.[19]

Sustainable investments and transition investments

Based on these different meanings of contribution to a sustainability objective in the EU's sustainable finance regulation, there are different definitions of investments in assets from a sustainability perspective. First, based on the **level of** social or environmental performance, assets or the investments in these assets can be defined as "sustainable" as long as they contribute to a social or environmental objective by already having a sustainable level of social or environmental performance. Second, there are investments in assets that do not perform sustainably yet, but where the assets **transition** their environmental or social performance

[14] The term "transition" can be used synonymously with impact since both terms refer to changes in social or environmental performance towards sustainability objectives. See, for example, the definition of transition finance provided by the OECD: "For the purpose of this paper, transition is defined as a journey to sustainable development, and transition finance as the financing of that journey." (OECD 2019, p. 11).

[15] See background information on the IMP below.

[16] IMP 2023

[17] It is important to note that in this context, the term "threshold" refers to sustainability performance measurement at asset level based on concrete KPIs. There are other usages of the term, for example the thresholds on portfolio level for transition or sustainable investments proposed in this paper. When using the term threshold, it is important to be clear about the level of analysis one is referring to, in this case asset versus portfolio level. ESMA provides another example of using the term threshold on portfolio level in their consultation on fund names where the thresholds refer to shares of investments in a portfolio that have certain ESG or sustainability-related characteristics (ESMA 2023).

[18] https://finance.ec.europa.eu/system/files/2022-03/220329-sustainable-finance-platform-finance-report-environmental-transition-taxonomy_en.pdf (p. 49)

[19] Although using societal and ecological thresholds in sustainability performance measurement is desirable, regulation needs to take into account limitations in practical implementation. See a proposal on how to introduce these kinds of thresholds in the SFDR framework below in the section "Proposed regulatory changes".

towards a sustainable level. Based on these understandings, the important concepts **on asset level** for the categories of financial products are:

(1) **Sustainable investments**: see definitions in the SFDR 2(17) and the EU Taxonomy 2(1). We propose to adopt these definitions of (environmentally) sustainable investments, including their do-no-significant-harm (DNSH) and other provisions. In these definitions the assets' economic activities contribute to a sustainability objective by having a **sustainable level of performance** (assets are already sustainable with reference to a sustainability objective).[20]

(2) **Transition investments**: Investments in assets whose economic activities contribute to a sustainability objective through transitioning towards a sustainable level of performance.[21] (assets are not yet sustainable but become sustainable with reference to a sustainability objective).

Importantly, the classification into a sustainable or transition investment always refers to a specific social or environmental objective. As a result, the same asset can be a sustainable investment with regards to one objective (e.g. climate change mitigation) but a transition investment when referring to another objective (e.g. securing human rights or labor issues). An example would be investing in renewable energy production that might have human rights or labor issues in the supply chain. The decision which perspective is taken (sustainable investment or transition investment) depends on the sustainability goal(s) that the financial product prioritizes.

Also, the level of or change in social or environmental performance can refer to all aspects of assets' activities, including own operations, upstream and downstream activities (see table 3 and 4 below). Again, the financial products sustainability objective needs to specify which aspects of assets' activities are prioritized, or whether all aspects (upstream, operations, downstream) are taken into account. In addition, although a sustainable investment already performs sustainably with reference to one specific sustainability objective, it can increase this already sustainable performance. This would be a positive impact or transition even though the social or environmental performance is sustainable already. Lastly, an investment can perform sustainable (or not) with regards to its own operations, while at the same time trying to achieve a positive impact or transition through its downstream activities (products and services), thereby influencing social or environmental outcomes for stakeholders and issues beyond the immediate control of the asset. To summarize, the financial product's sustainability objective would need to specify (1) the sustainability goal(s) it wants to contribute to, (2) the type of investments it

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[20] For a proposal on how to improve SFDR's definition of sustainable investments see section "Proposed regulatory changes".

[21] We are aware that this definition is only a first proposal and would need to be specified in order to be applicable in practice. For example, The definition of transition investments could also include a DNSH principle stating that assets are only allowed to perform unsustainably with regards to the sustainability goal the financial products aims to positively influence (e.g. climate change mitigation). Also, this definition of transition investments is broader than the definition of transition activities in Article 10(2) of the [EU taxonomy] since it does not only refer to the goal of climate change mitigation.

aims at (transition and/or sustainable investments) (3) the type of asset activity it focuses on (upstream, operations, downstream) and (4) whether it aims for investor contribution.

Investor contribution

The current EU sustainable finance regulation is missing the concept of investor impact or investor contribution. An academic definition of investor impact is provided by Kölbel et al, who define investor impact as "change that investor activity achieves in company impact" (2020).[22] In practice, the term investor contribution is more common. We propose to define investor contribution as "The contribution that the investor makes to enable enterprises (or intermediary investment managers) to achieve impact."[23]. This definition is used by the Impact Management Platform, a collaboration between providers of sustainability standards and guidance, whose goal is to mainstream the practice of impact management.[24] This definition is, therefore, shared by many important actors and Stakeholders since Partners in the IMP include, among others, the Organisation for Economic Co-operation and Development (OECD), the United Nations Environmental Program Finance Initiative (UNEP-FI), the International Finance Corporation (IFC), the United Nations Development Program (UNDP), the Global Reporting Initiative (GRI), the Capitals Coalition, and the Global Impact Investing Network (GIIN).

[22] https://journals.sagepub.com/doi/epub/10.1177/1086026620919202. Company impact is then defined as "change that a company's activities achieve in a social or environmental parameter", which is consistent with the definition of contribution as change or impact discussed above.
[23] https://impactmanagementplatform.org/terms-and-concepts/
[24] https://impactmanagementplatform.org

Proposed regulatory changes

Based on the categories for financial products and the key concepts proposed above, we argue that the following changes to the EU Sustainable Finance Framework would be necessary:

SFDR level 1

Article 8:

1. Delete the concept of environmental and social characteristics from SFDR.
2. Add ESG Products as new Article 8 Products to have a clear distinction between Article 8 and 9 products and as an alternative to the ambiguous concept of environmental and social characteristics.
3. Specify that the management of ESG risks and/or opportunities (outside-in perspective) as used by ESG products is not part of the categories of impact products (i.e. transition and sustainability focused products). This is consistent with approaches in other jurisdictions like the categories proposed by the Financial Conduct Authority in the United Kingdom.[25]

Article 9:

4. Introduce the proposed product categories (1) transition products and (2) sustainability focused products as two versions of Article 9, including the 70 percent thresholds and the three defining characteristics (sustainability objective, investment strategy, sustainability performance measurement).
5. Add the definition of transition investments.
6. Add the definition of investor contribution.
7. Specify the definition of sustainable investments in SFDR article 2(17) by differentiating the two types of positive contribution to sustainability objectives described in this position paper (i.e. differentiate positive contributions through an already sustainable level of performance from positive contribution through a change towards sustainable performance). This would increase the coherence of the terminology between SFDR and ESRS.
8. Specify the definition of sustainable investments in SFDR article 2(17) by adding the concept of societal or ecological thresholds on asset level to the definition of positive contribution to sustainability objectives as proposed in this position paper. In this context, the SFDR should also include rules for financial market participants to publish

[25] "products using strategies such as ESG integration or basic ESG tilts alone would not qualify for a label." (FCA 2023, p. 23). The FCA defines ESG integration as "Ongoing consideration of ESG risks and opportunities within an investment analysis and decision-making process, to assess their implications for risk-adjusted returns. (FCA 2023, p. 92).

the thresholds used in the measurement of positive contribution towards a sustainability objective.[26]

9. Based on the proposed categories for financial products in this position paper, the EU Commission could introduce consistent naming rules for financial products that do and do not qualify for the categories.

MiFiD II/IDD

10. Use the proposed financial product categories as a basis to define sustainability preferences to help (retail) investors and support the allocation of capital to sustainable and transition investments.

Summary

The proposed classification of financial products helps developing the EU's Sustainable Finance Framework, especially in the context of the SFDR level 1 review. The proposed categories would help identify financial products with clear sustainability goals, and the processes necessary to achieve these goals. The proposal uses existing concepts wherever possible (e.g. sustainable investments), clarifies and specifies existing concepts where necessary (positive contribution) and adds new terms where they are needed (e.g. transition investments or investor contribution). This way, the burden of transitioning to new regulatory categories for financial products can be reduced as much as possible.

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[26] Including societal and ecological thresholds in the definition of positive contribution is essential, but at the same time, limitations regarding practical implementation remain. Future sustainable finance regulation in the EU needs to find the right balance between prescribing concrete thresholds which increases comparability (like done in the EU-Taxonomy) and leaving flexibility for different context to increase practical implementation and contextual validity. The goal should be that using norm- or science-based societal or ecological thresholds becomes common practice when measuring sustainability performance as soon as possible.

Table 2: Comparison of proposed categories with other proposals:

Product Categories	Transition Products		Sustainability Focused Products	
SFDR[27]		D-Products	A-Products (Downstream) B-Products (operations)	
FCA[28]	Sustainability Improvers	Sustainability Impact	Sustainability Focus	-
AFM[29]		Transition Product	Sustainable Product	Sustainable Impact Product
Investor contribution	Impact-aligned	Impact-generating	Impact-aligned	Impact-generating

[27] https://finance.ec.europa.eu/document/download/99bc25fe-4dd8-4b57-ab37-212b5ab05c41_en?filename=2023-sfdr-implementation-targeted-consultation-document_en.pdf
[28] https://www.fca.org.uk/publication/policy/ps23-16.pdf
[29] https://www.afm.nl/~/profmedia/files/rapporten/2023/afm-position-paper-on-improving-the-sfdr.pdf

Table 3: Sustainable investments in relation to societal or ecological thresholds

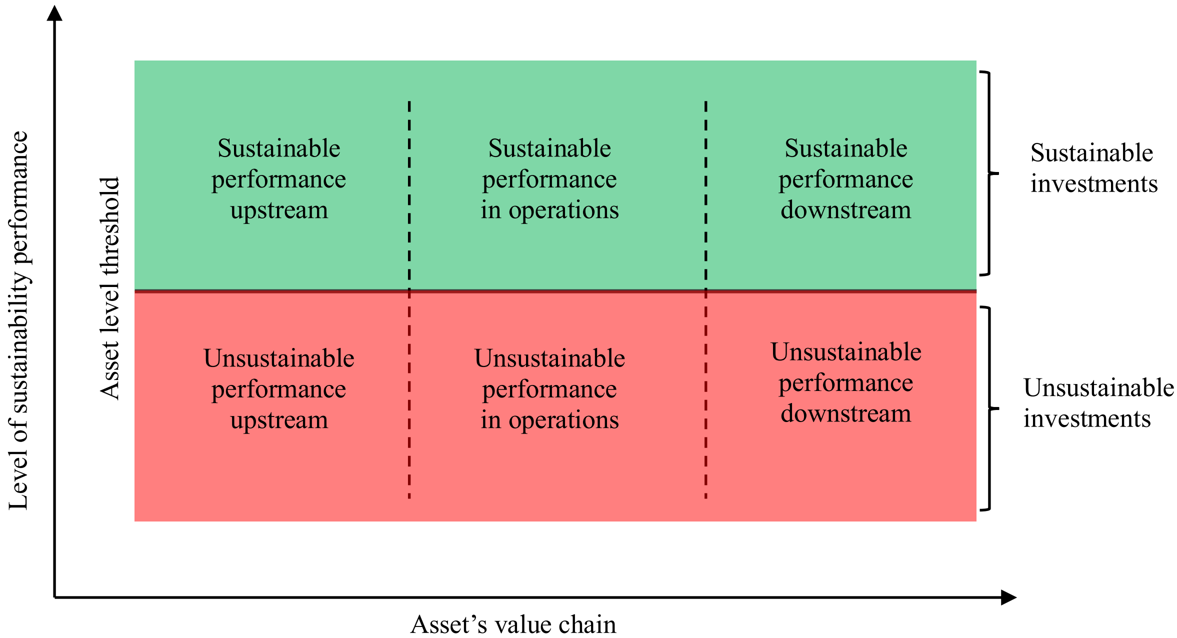

Table 4: Transition investments in relation to societal or ecological thresholds