OVERVIEW OF SFDR CLASSIFICATIONS IN THE FRENCH FUNDS' UNIVERSE AND PORTFOLIOS' EXPOSURE TO FOSSIL ENERGIES AT THE END OF 2021

Executive summary:

The **Sustainable Finance Disclosure Regulation** (**SFDR**) of 2019 came into effect on 10 March 2021 and aims to encourage the orientation of capital flows towards sustainable activities through the harmonisation and reinforcement of environmental and social transparency requirements in the financial services sector, including asset management. The transparency requirements are proportional to the stated environmental and social ambition.

In order to assess the environmental and social ambition of financial products, SFDR introduces a classification organised around three categories:

- *"**Article 9**"* financial products, which have a *sustainable investment objective*;
- *"**Article 8**"* products, which *promote sustainable characteristics* taking ESG criteria into account within the framework of the investment process but without pursuing a sustainable investment objective;
- "**Article 6**" financial products, which come within neither of the two preceding categories and can therefore not announce sustainable characteristics in their communications with investors.

The concept of "**sustainable investment**" is defined by the SFDR (Article 2(17)) very generally as an investment in an economic activity that contributes to an environmental or social objective, provided that such investments do not significantly harm other environmental or social objectives and that the investee companies follow good governance practices.

The SFDR requires that all financial products, whatever the stated sustainability ambition, disclose information on how environmental, social and governance (ESG) risks are taken into account, as well as the potential impact of those risks on the value of investments. For financial products stating an environmental and social ambition (Article 8 and Article 9), additional information is required since the start of 2023: the regulatory documentation shall contain qualitative and quantitative information on how the promoted characteristics are complied with, and where applicable how the objectives are achieved.

It is essential to understand the philosophy of the SFDR, which is very atypical: the aim is to combat greenwashing by requiring that those market participants who claim a sustainable approach for their financial products disclose information enabling investors to make their own assessment of the products' sustainability. In this regard, the slightest mention of a sustainable characteristic in a product's documentation is sufficient to consider it as coming under Article 8 of the SFDR ("promotion of sustainable characteristics"), and therefore imposes the publication of additional information. The classification of a fund in the Article 8 category of SFDR is therefore neither a label nor a guarantee of quality.

With regard to Article 9 funds, the European Commission specified in a Questions and Answers document released in July 2021 that they should comprise only sustainable investments within the meaning of SFDR (with the exception of investments made for liquidity or hedging purposes).[1] Yet, as the proposed definition leaves substantial room for interpretation when assessing the sustainable nature of an investment, a given investment could be considered sustainable by one market participant and not so by another. Therefore, the Article 9 category of SFDR does not constitute either a label or a guarantee of quality.

This study is not intended to represent an SFDR compliance exercise. The aim above all is to produce an overview of the SFDR classification for the French asset management market as a whole at end-2021. Secondly, and following on from the AMF-ACPR joint report on monitoring of the climate commitments of participants in the Paris marketplace published in the autumn of 2022,[2] the characteristics of French investment funds, and in particular their SFDR classifications, are compared with the composition of their portfolios, again at end-2021. The main focus is on exposure to fossil energies, which is the subject of special attention by several external stakeholders, even though this link is absent from the regulations in force.

SFDR classification of French investment funds:

At 31 December 2021, one-fifth of French funds, representing half of the assets under management promoted environmental or social characteristics ("Article 8 funds") or claimed a sustainable investment objective ("Article 9 funds").

- Article 8 funds by themselves account for 19% of the market by number and 47% of assets under management. This SFDR category represents nearly all the net assets of money market funds and around 50% of the assets of French equity and bond funds.
- Article 9 funds account for 2% of the number and 3% of the total net assets of French funds. These funds are more represented among equity funds.
- **Two-thirds of the asset management companies studied report no Article 8 or Article 9 fund.**

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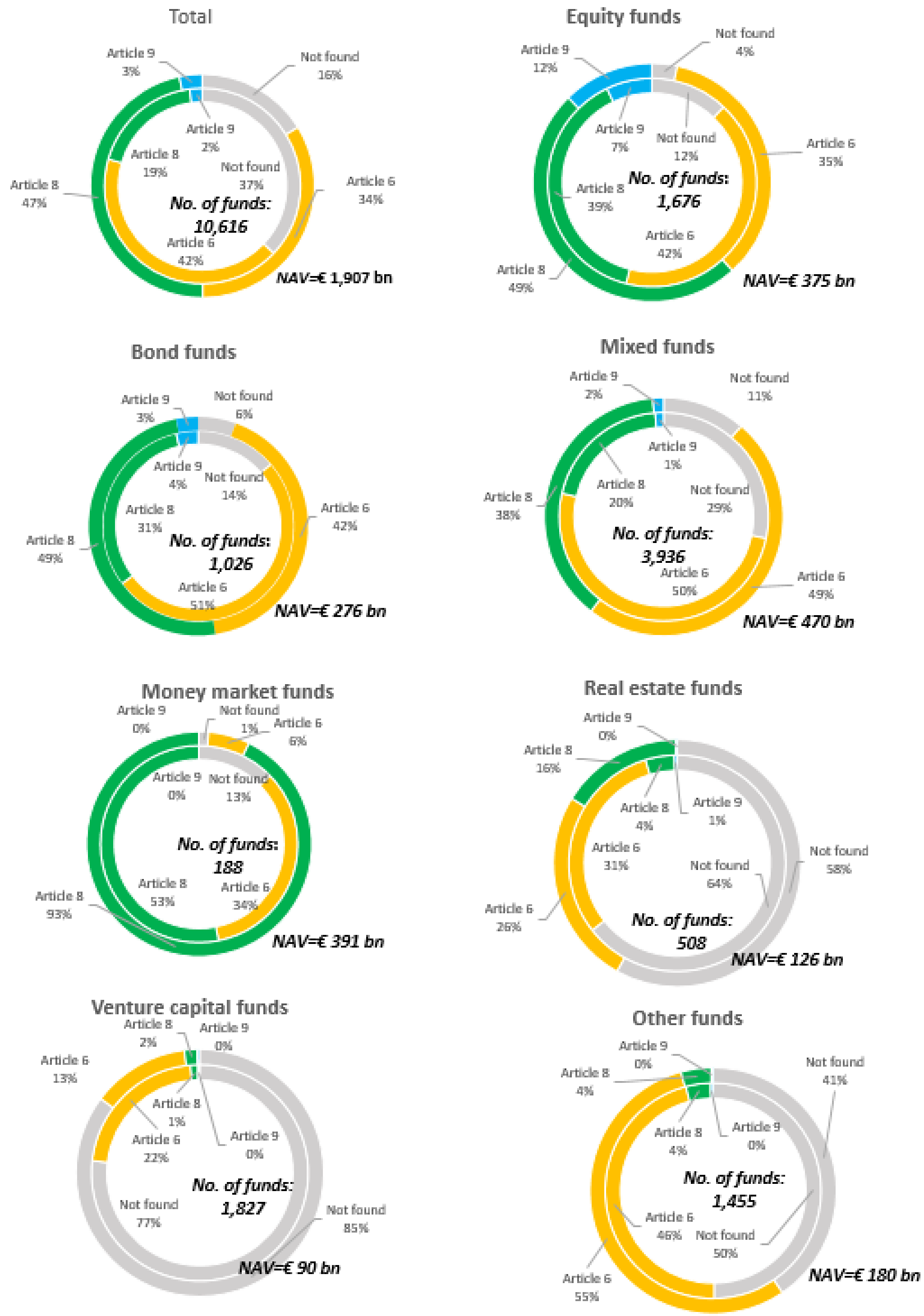
For one-third of the funds and about one-fifth of assets under management, information on the classification adopted is not available even though it should be. These are mainly real estate and private equity funds created before 2021 and which were no longer open to marketing when the SFDR came into force.

[1] *Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088*)

[2] ACPR, AMF (2022). Monitoring and assessment of the climate commitments of participants in the Paris marketplace – Third ACPR/AMF joint report. October 2022, 129 p.

Breakdown of the French market by volume for 2021 (total NAV of €1,907 billion)



Source: AMF (BIO), Thomson Reuters Lipper, Morningstar, AMF calculations
NB: The inner circle indicates the proportion of each category measured in terms of the number of funds, while the outer circle presents these proportions relative to net assets. The "Not found" category corresponds to funds for which the SFDR category was unable to be identified.

<u>Composition of the portfolios of investment funds (environmental characteristics) according to their SFDR classification:</u>

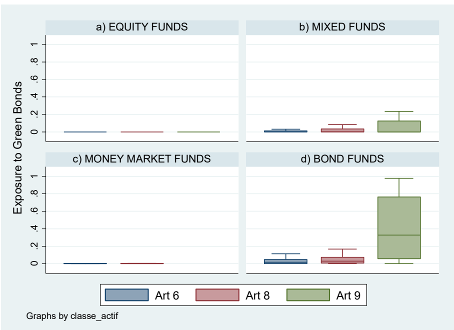
The fight against climate change and portfolio decarbonisation are now significant issues for financial market participants. Several variables of interest are analysed with regard to the SFDR classification for the four main fund categories (equity, bond, diversified and money market funds):

- Funds' exposure to green bonds, sustainability-linked bonds (SLBs), social bonds and sustainability bonds;
- Funds' exposure to coal and oil & gas developers (i.e. companies which are increasing their production capacity in these sectors) and, more generally, exposure to companies active in the fossil energies sector. Regarding this point, the analysis is supplemented by an attempt to take into consideration the credibility of the transition plans of issuers in these sectors present in the funds' portfolio (additional estimates are produced by removing from the exposure metrics those companies whose plans are judged most credible by the UN "Assessing Low Carbon Transition" methodology).

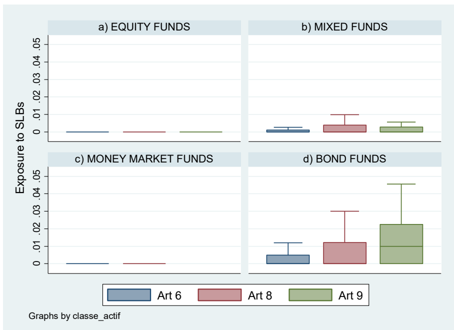
It is essential to remember that **the SFDR introduces transparency requirements but does not at this stage create any conduct requirement for market participants. For example, Article 8 and 9 fund managers are not legally prohibited from investing in securities of fossil fuel developers and coal, oil or gas producers. Moreover, in the current state of the legislation, there is nothing which, in law, establishes a clear and explicit link between such activities and the concept of significant harm referred to in the SFDR. However, since the start of 2023, the SFDR requires that, for these funds, specific information be disclosed, e.g. concerning the proportion of the portfolio invested in these sectors.**

Distribution of the proportion of green bonds, SLBs, social bonds and sustainability bonds in the portfolio of French funds, by asset class and SFDR classification

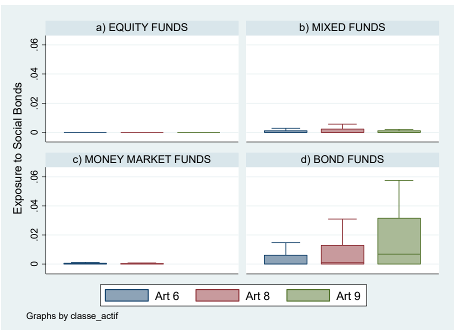
Green bonds



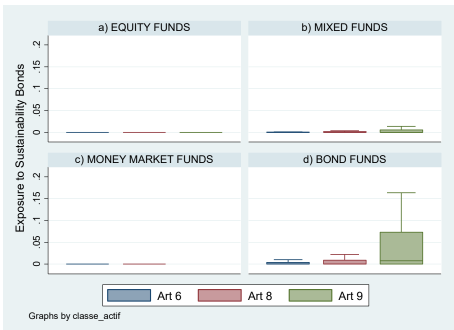
Sustainability-linked bonds



Social bonds



Sustainability bonds



<u>Source: Banque de France ("OPC titres" database), Lipper, Morningstar, Bloomberg, AMF</u>

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The main observations at end-2021 are as follows:

1) Bond funds and diversified funds invest significantly in green, sustainability and social bonds and in sustainability-linked bonds. The weight of these assets is greater in funds classified as Article 8 or Article 9 funds.

2) Regarding the funds' exposure to fossil energies, the results vary depending on the data source used (in this case Urgewald and Trucost) to measure exposures and the fund category analysed. **Generally speaking, Article 8 and Article 9 equity funds have lower exposure to fossil energies. The results are far less clear for the other fund categories, especially bond funds. In particular, the differences between Article 8 and Article 6 funds are seldom significant in the statistical sense of the term, which suggests that the definition of Article 8 funds is probably not very discriminating.**

- ↗ More specifically, concerning the **coal sector**:
  - ✓ **Equity funds'** exposure is significantly lower for Article 8 and Article 9 funds than for Article 6 funds. In contrast, the difference between the exposure of Article 8 funds and that of Article 9 funds is more seldom significant.
  - ✓ Article 8 and Article 9 **bond funds** are in many cases significantly more exposed than Article 6 funds.
  - ✓ For **diversified funds**, the results differ depending on the data sources used. The exposures of Article 8 and Article 9 funds are lower than for Article 6 funds but only with the Urgewald data source and, in the case of Article 8 funds, only when exposures to sustainability bonds and companies whose transition plans can be considered credible are taken into account.
  - ✓ No statistically significant difference is noted between Article 6 and 8 money market funds.

- ↗ As regards the **oil and gas sector**:
  - ✓ The exposures of sustainability **equity funds and diversified funds** are lower than those of Article 6 funds, but only according to the Urgewald data source.
  - ✓ Regarding **bond funds**, the differences are at best statistically non-significant, unless one deduct from the exposure investments in bonds financing environmental projects.
  - ✓ The differences are statistically non-significant for **money market funds**.

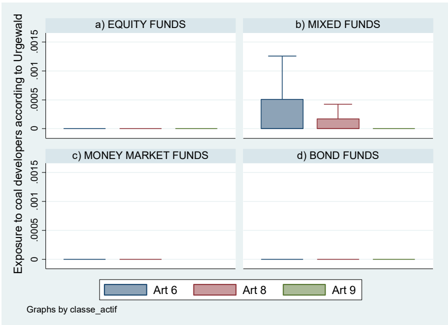
3) Focusing on the restricted universe of fossil fuel developers:

- ↗ In general, the results differ depending on the source used to identify them and the asset class in question.
- ↗ According to Urgewald, coal developers are found only in diversified funds and their weight, which is very small moreover, is less for Article 8 funds than for Article 6 funds and proves insignificant for Article 9 funds. The exposures measured with Trucost data are even more limited.
- ↗ The exposure to oil & gas developers is more significant but remains low. Equity funds and diversified funds classified as Article 9 seem to be less exposed than the Article 6 equivalents. On the other hand, Article 8 funds seldom differ significantly from Article 6 funds.
- ↗ A specific analysis of Article 9 funds allows us to identify the main fossil fuel developers present in their portfolios. Out of 207 funds classified as Article 9 at end-2021, representing total net

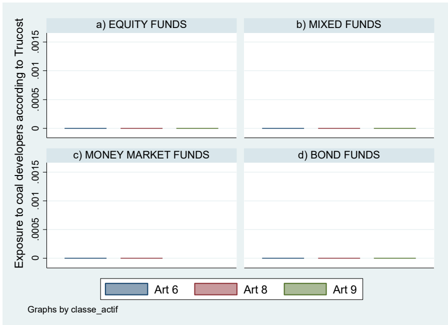
assets of €61 billion, and based on the lists established by Urgewald, at the end of 2021 coal developer groups concerned 17 funds and represented €16 million in assets under management. Part of these funds were declassified as Article 8 funds in 2022. Oil & gas developer groups, for their part, concerned half of the funds under review and represented €1.4 billion.

Distribution of the proportion of coal and oil & gas developers in the portfolio of French funds by asset class and SFDR classification

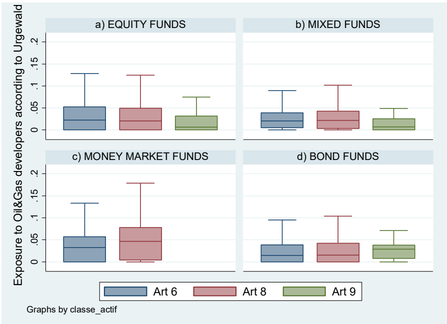
Coal developers according to Urgewald



Coal developers according to Trucost



Oil & gas developers according to Urgewald



Source: Banque de France ("OPC titres" database), Lipper, Morningstar, Urgewald, Trucost, AMF

Unlike a labelling mechanism, the SFDR regulation stipulates no minimum requirement and basically asks financial market participants to disclose information relating to their non-financial claims and practices. This study confirms the observations made by the AMF in the past few months that products "categorised" as Article 9 and Article 8 refer to very heterogeneous ambitions and practices, notably with regard to climate commitments. This therefore makes it very difficult to recognise sustainability products implementing the most ambitious and robust non-financial practices. Accordingly, the application of the SFDR in its current state could result in a divergence between the expectations expressed by investors and actual practices, thus contributing to a loss of credibility of the ecosystem, misunderstanding or even a risk of greenwashing. Faced with this risk, the Autorité des Marchés Financiers (AMF) has, moreover, declared itself in favour of introducing minimum environmental criteria that financial products should comply with in order to be classified as Article 9 or Article 8 under the SFDR, and has issued proposals concerning them.[3] At the same time, the AMF is developing an automated reading tool to industrialise the detection of SFDR classifications based on the prospectuses and thereby allow dynamic monitoring of changes in disclosure.

[3] Proposed minimum environmental criteria for financial products of the Art.9 and Art.8 categories of the SFDR (13/02/2023)