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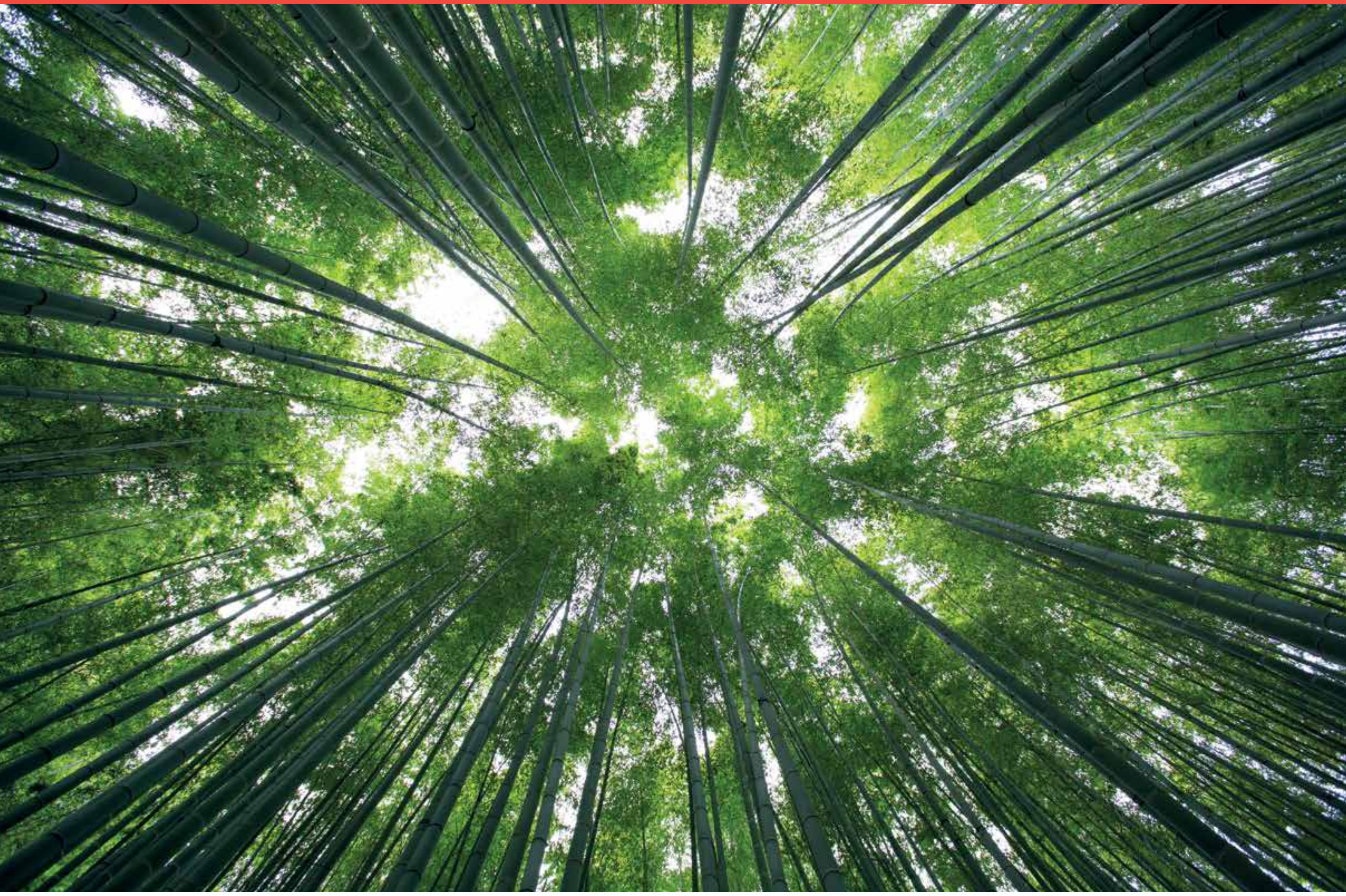
# The state of ESG disclosure in Asset & Wealth Management – From fund issuer to end investor



# Preface

Dear readers

Sustainability is becoming an increasingly important topic for consumers. In many areas, an understanding and awareness of sustainability has strongly developed, which is now slowly spreading to areas of life that are less tangible such as finance and financial services. When it comes to raising the money for the transformation towards a sustainable economy, the capital market has never had such a socio-political significance. Consumers are willing to put their money on the capital market to get the climate transformation started. The question is how successfully the capital market and sales and distribution side are currently able to set consumer expectations. Especially younger generations believe that banks can make a valuable contribution to sustainability. Therefore, they demand more transparency and enough options to invest in sustainable finance products.

The financial industry is now confronted with implementing the regulatory requirements resulting from EU's comprehensive Sustainable Finance Action Plan in a way to meet the changing consumer needs. In this study we took a snapshot investigation of the market to find out how good the market fulfills already these expectations. We investigated the current sustainable product offerings of asset managers, perspectives of the next generation of clients on sustainable product offerings, and key challenges that distributors of funds are currently facing to align investment products with investor preferences and expectations.

We would like to thank all participants of the study and hope you find the results of our assessment insightful, which should stimulate discussions to get the transformation in the financial services market further going.

Best wishes

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# A Management summary

Our three folded study investigating the sustainable product offering of asset managers, examining the next generation clients' perspective on sustainable product offerings, and elaborating the key challenges for distributors allows a wholistic view on the actual status and upcoming quo vadis of sustainability in the Asset and Wealth Management industry. Besides regulation as key driver for ESG in the industry, there is a "pull effect" by increasing demand for sustainable products, as especially younger generations assess sustainability as increasingly important. Manufacturers have already reacted and expanded their range of funds for ESG-oriented investors, with the EU Sustainable Finance Disclosure Regulation (SFDR) further accelerating growth. However, a large proportion of clients and investors is dissatisfied with the provided information regarding the sustainability profile of financial products. At the same time, distributors notice that this information is an important prerequisite for their sales activities but are not satisfied with the information provided by manufacturers. This is comprehensible as asset managers have taken a wide variety of approaches to product classification according to SFDR, with some more conservative than others. SFDR classification is associated with certain disclosure requirements but does not constitute a formal ESG label. There are several regulatory requirements ahead to close this information gap and create more transparency regarding the sustainability profile of financial products. On the one hand, important supporting rules for SFDR, so-called regulatory technical standards (RTS, Level II), will be applicable from July 1, 2022. They provide templates and require disclosing dedicated sustainability information on product level rather than more generic phrases. On the other hand, the MiFID II ESG amendments, applicable from 2 August 2022, require to assess sustainability features of financial products when determining the target market and to consider clients' sustainability preferences in investment advice. Due to the wide variety of approaches to product classification according to SFDR, reputational risks could arise for asset managers if e.g. Art. 8 products are not suitable under MiFID II to serve clients' sustainability preferences. With these regulatory requirements ahead the biggest challenges to comply will be the availability of sustainability data, providing it to distributors and investors, and at the same time to ensure a transparent investment advisory process. Whether the regulations ahead close the information gap demanded by consumers and distributors remains to be seen. The transition towards sustainability in asset and wealth management is only just beginning and there is still a long way to go.

# Key takeaways of the study

1 Based on data as of 20 May 2021 we estimate that funds classified as Article 8 or 9 according to Sustainable Finance Disclosure Regulation (SFDR) represent roughly 22% of the overall number of funds on the European fund market, and up to 32% of European assets under management (AUM).

2 Asset Managers have taken different approaches based on their interpretation of SFDR, resulting in a wide range of investment products classified as Article 8 and 9 with respect to their sustainability profile, with some being more conservative than others.

3 SFDR classification does not constitute an ESG label. Article 8 funds tend to have a higher sustainability profile than conventional funds – and Article 9 funds even more so – but this is by no means guaranteed, and consumers should make sure that they understand individual funds' ESG objectives and investment process.

4 Sustainability is becoming an increasingly important topic for consumers. A clear majority across all age groups agree that measures to implement sustainability represent not just a trend but a long-term systemic change.

5 Younger generations – the asset holders of the future – want transparency and enough options to invest in sustainable financial products. These developments mean that the financial industry must ensure greater transparency on sustainability issues and respond to consumers' changing needs.

6 Distributors of financial products anticipate a clear shift in consumer demand towards sustainable products. Almost one-third of the distributors surveyed are planning to take the strategic decision to completely discontinue the sale of conventional products that do not include any reference to ESG.

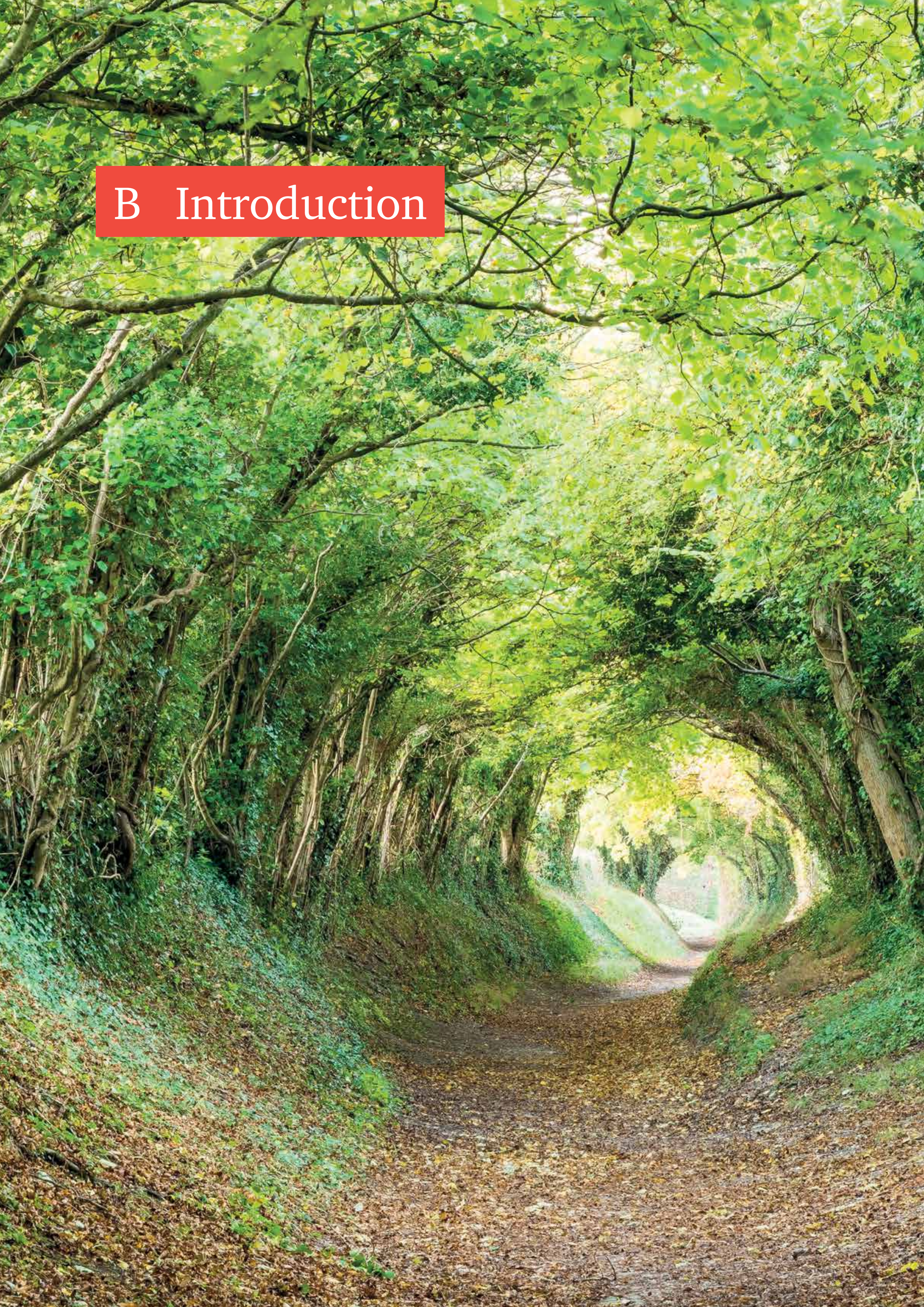
7 Asset Managers are feeling the pressure from distributors and consumers and many of them are planning to bring additional funds into the Article 8 and 9 categories by enhancing existing strategies, reclassifying funds, and launching new ones.

8 While consumers want to adjust their portfolios towards a more sustainable one, a large proportion is currently dissatisfied with the provided information regarding sustainability of financial products and transparency.

9 Distributors consider dedicated product information regarding sustainability to be essential for sales activities, but more than 50% are not satisfied with the information currently available from providers of financial products.

10 Distributors are facing many challenges in implementing ESG regulations. They name availability of data necessary to meet regulatory requirements as the biggest challenge, followed by the challenge of ensuring a transparent investment advisory process while complying with complex regulatory requirements.

# B Introduction



The European Commission has drawn up an ambitious sustainable roadmap towards achieving the targets agreed at the Paris climate conference.[1] Published in 2018, the EU's comprehensive Sustainable Finance Action Plan provides the framework for implementing environmental policy objectives and aims to reorient capital flows towards sustainable investments, embedding sustainability in risk management. It also aims to foster transparency as a basis for financial market participants and financial advisers to adequately assess long-term value creation from a more sustainable and long-term perspective. A substantial part of these financial flows will have to come from the private sector, and this requires redirecting private capital flows towards more sustainable investments. Even though regulatory requirements have not yet been finalised, affected players must act at an early stage and thus offer sustainable products on the market.

This study assesses three key aspects of the new paradigm of sustainable finance. First, we examine the status quo of the investment market and how sustainable products have been classified under the Sustainable Finance Disclosure Regulation (SFDR) since March 2021. We then investigate what relevance bank clients and investors (particularly younger generations) attach to sustainability in the financial industry. To do this, we conducted a survey in the German and Swiss markets and asked not only how important sustainability is for consumers, but also how much involvement they expect from financial institutions and what the financial industry can do to improve customer satisfaction on sustainability. Finally, we take a look at the perspective of the sales and distribution side to show what still needs to be done in order to sell sustainable products to institutional clients and to younger generations. This involved conducting a survey targeted at distributors in the German and Swiss markets, investigating what role sustainability currently plays in product sales to investors within asset and wealth management.

We would like to take this opportunity to thank everyone who took part in this study.

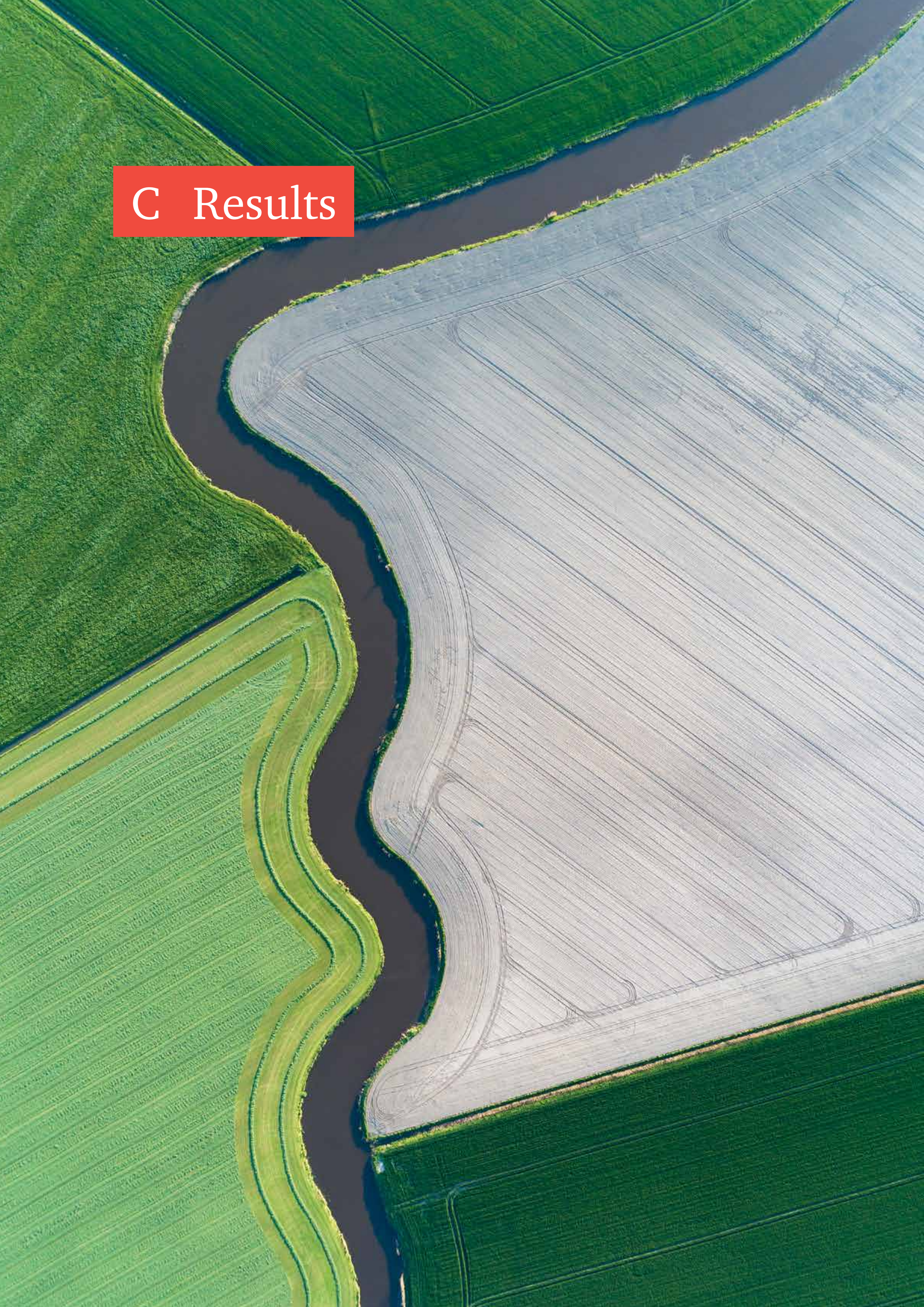
## Thank you for your contribution to protecting the climate!

We have rewarded your contribution to this study with a donation to the Panguana Foundation, enabling the foundation to acquire round about 9 hectares (90,000$m^2$) of additional land in the surrounding Peruvian rainforest – equivalent to around 14 football pitches, or roughly the size of Frankfurt Zoo.

Panguana is a renowned model in Peru, and is internationally respected for its successful combination of nature conservation, climate protection, scientific research and social projects which underpin the importance of preserving the rainforest. For more information, please visit www.panguana.de.

[1] The Paris Agreement is the first ever universal, legally binding global climate agreement, adopted at the Paris climate conference in December 2015. The EU and its member states are among the 190 parties to the Paris Agreement. In December 2020, the EU submitted its updated and enhanced target to reduce greenhouse gas emissions by at least 55% compared to 1990 levels by 2030.

# C Results



## 1 Sustainable products: the evolving SFDR landscape

**A first snapshot view**

After almost three years of preparation, the EU Sustainable Finance Disclosures Regulation took effect on 10 March 2021.

In order to meet its goal of carbon neutrality by 2050, the EU is further ramping up its sustainable finance efforts. Back in March 2018, the European Commission adopted the ten-point Sustainable Finance Action Plan, with the aim of channelling capital flows towards sustainable investment while managing financial risks stemming from environmental, social and governance (ESG) issues. A core element of the EU Sustainable Finance Action Plan is the Sustainable Finance Disclosure Regulation (SFDR).

The SFDR aims to increase transparency about sustainability risks in the financial sector by requiring financial market participants and financial advisors to disclose both the intended positive sustainability effects and any negative externalities involved in funds.

"Article 8 and 9 funds represent nearly a third of European fund assets."

Under the SFDR, the entire universe of European funds must be classified by their managers into one of three categories: Article 6, 8 or 9 funds. This nomenclature is derived from the text of the regulation; all funds will be required to provide at least some ESG disclosure (as per Article 6), while Article 8 and Article 9 funds will be required to provide more detailed ESG information to investors. Article 8 funds promote environmental or social characteristics and Article 9 funds have an explicit sustainable investment objective.

Although uncertainties remain about the Article 8 and Article 9 classification, Morningstar has started collecting this data from fund prospectuses to help investors to identify these funds. Article 8 and 9 data points were first released by Morningstar on 29 March 2021 on a subset of the European fund market, and coverage of the fund universe has been expanded ever since.

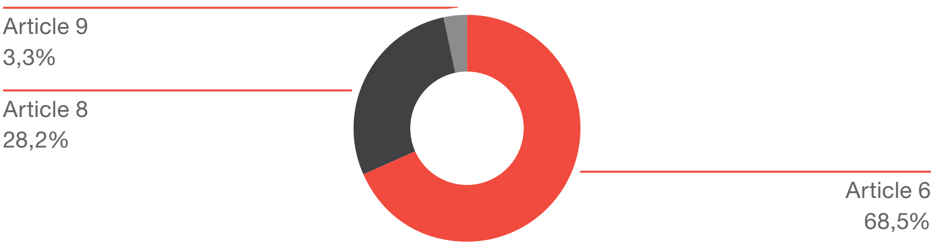
Morningstar provided an overview of the new disclosures in two reports published in March and April 2021 (*SFDR – The First 20 Days and European Sustainable Fund Flows: Q1 2021 in Review*). This report provides an update based on data collected by Morningstar's data team up to 20 May 2021.

As of 20 May, Morningstar's data team had reviewed 47% of the 34,000[2] open-end funds and exchange-traded funds available for sale in Europe, representing 64% of assets under management (AUM).[3]

Based on the data collected so far, we estimate that funds currently classified as Article 8 or 9 represent roughly 22% of the overall number of funds on the European fund market, and 32% of AUM.

Most of these were classified as Article 8 funds (28.2% of assets), while Article 9 funds accounted for 3.3% of assets. Based on data coverage as of 20 May 2021, using SFDR definitions and excluding money market funds, feeder funds and funds of funds, the European ESG and sustainable funds market is worth as much as €2.3 trillion. We expect this to increase in the coming months as asset managers enhance strategies, repurpose funds and launch new ones that meet Article 8 or 9 requirements.

**Fig. 1 SFDR breakdown (percentages of AUM under Articles 6, 8 and 9 in the European fund market)**




Source: Morningstar. Data as of 20 May 2021.

[2] 40,000 funds including money market funds, fund of funds and feeder funds.

[3] This includes funds domiciled in Luxembourg, Europe's largest fund domicile, where data was collected on around 7,800 funds, representing 90% of AUM. Coverage was highest in Scandinavia, the Netherlands and Belgium, where it exceeded 90%, followed by France and Germany with more than 70% of assets recorded. Coverage of funds domiciled in Ireland, the second-largest European domicile, was 61% of assets (approx. 1,600 funds).

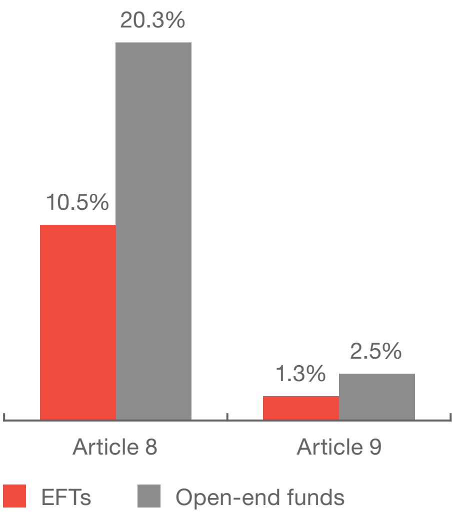
> Active funds are more likely to be classified as Article 8 or 9 than passive funds."

Active funds are more likely to be classified as Article 8 or 9 than passive funds, as shown in Figure 2.

Of the exchange-traded funds (ETFs) reviewed so far (46% of all ETFs available for sale in Europe[4]), 11.7% have been assigned to the Article 8 or 9 categories, while this figure was 22.8% for open-end funds. Most open-end funds (93%) are classified as active funds.

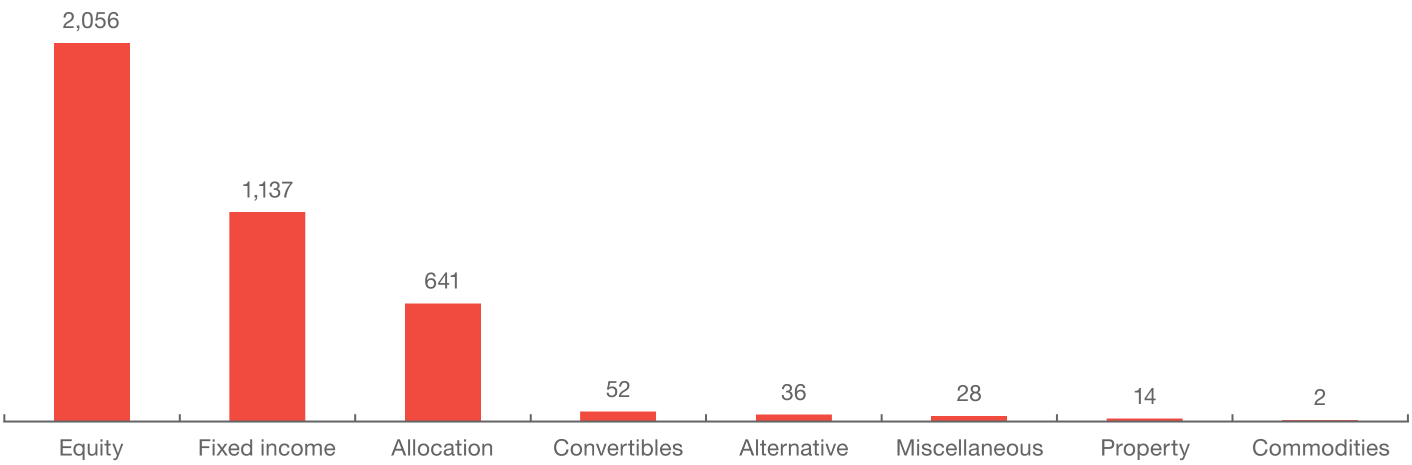
Based on the data collected so far, the number of Article 8 and 9 funds is highest in the equity asset class, followed by fixed-income funds and allocation funds (see Figure 3).

**Fig. 2 Percentages of ETFs and open-end funds classified as Article 8 or 9**




Source: Morningstar. Data as of 20 May 2021.

**Fig. 3 Article 8 and 9 funds by broad asset class**




Source: Morningstar. Data as of 20 May 2021.

[4] Excluding money market funds, fund of funds and feeder funds.

Despite equity funds dominating the Article 8 and 9 universe, several of the largest Article 8 funds are fixed-income funds (see Figure 4).

**Fig. 4 The largest Article 8 or 9 funds by SFDR classification**

| Name | SFDR fund type | Asset class | Sustainable investment? | AUM (€bn) |
|---|---|---|---|---|
| AB American Income C Inc | Article 8 | Fixed income | No | 20.7 |
| AB Global High Yield I Inc | Article 8 | Fixed income | No | 16.8 |
| hausInvest | Article 8 | Property | No | 16.7 |
| Fidelity Global Technology A-Dis-EUR | Article 8 | Equity | No | 11.6 |
| Pictet-Global Megatrend Sel I USD | Article 8 | Equity | No | 11.5 |
| Allianz China A Shares AT USD | Article 8 | Equity | No | 10.6 |
| JPM Emerging Markets Equity A (dist) USD | Article 8 | Equity | No | 10.2 |
| Robeco High Yield Bonds DH € | Article 8 | Fixed income | No | 9.1 |
| Fidelity Global Dividend I-Acc-EUR | Article 8 | Equity | No | 8.6 |
| Opcimmo LCL Opcimmo | Article 8 | Property | Yes | 8.4 |

Source: Morningstar. Data as of 20 May 2021.

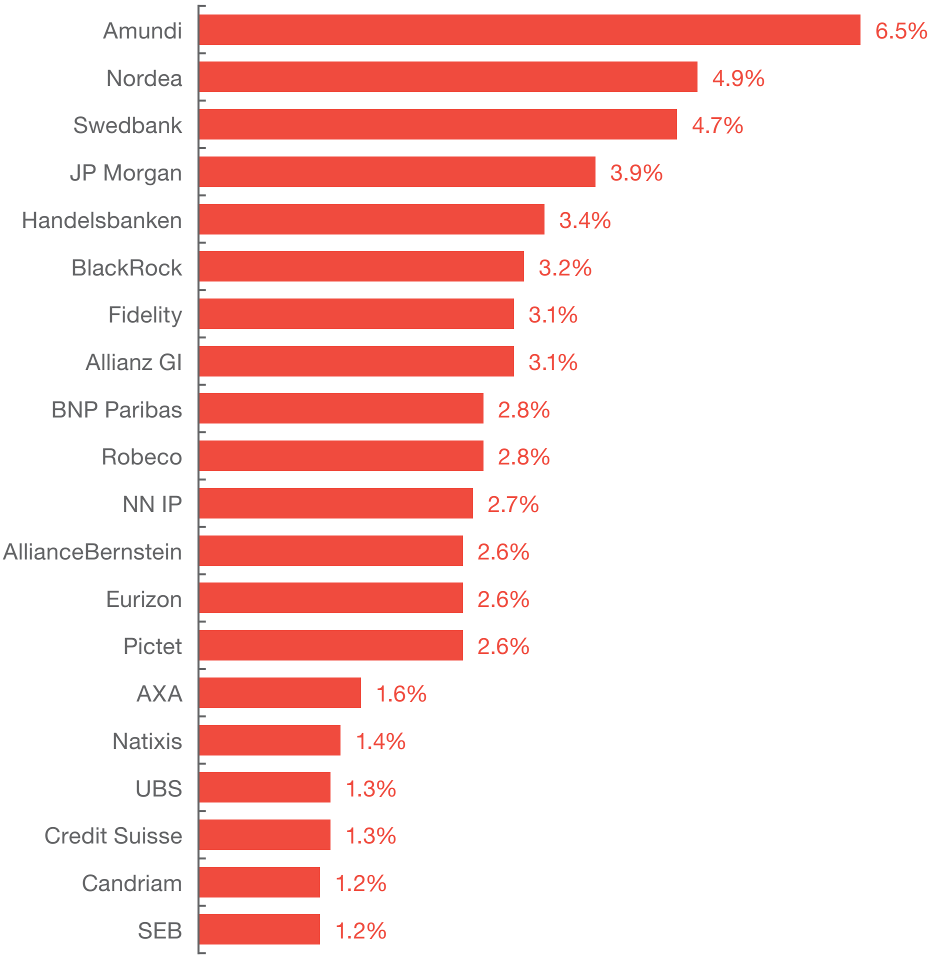
## Asset manager ranking

Figure 5 ranks the 20 asset managers with the most Article 8 and 9 fund assets, based on SFDR data representing 82% of the EU fund universe, and excluding money markets, feeder funds and funds of funds.[5] Amundi tops the league table with a 6.5% share of total Article 8 and 9 AUM, followed by Nordea and Swedbank.

Since the introduction of the SFDR in March 2021, many asset managers have upgraded funds and launched new ones classified as either Article 8 or 9.

Many of the asset managers surveyed feel that it is essential to have as many funds as possible classified under Article 8 or 9. They see the SFDR as an opportunity to demonstrate their commitment to sustainable investing. They are also feeling pressure from some distributors and fund buyers that have said they would only consider Article 8 or 9 funds going forward.

**Fig. 5 Asset managers ranked by total Article 8 or 9 fund assets**




Source: Morningstar Direct, filtered by brand name and based on AUM data as of 30 June 2021, excluding money markets, feeder funds and funds of funds.

[5] See Morningstar, "SFDR: Four Months After Its Introduction", available at: www.morningstar.com/en-uk/lp/sfdr-four-months-after-its-introduction.

### Morningstar applies a stricter definition of "sustainable investment"

Based on the data collected so far, the Article 8 category represents the largest and most diverse group of funds, from "ESG integrated" (very light green) to sustainable (dark green) strategies. This was to be expected in the case of Article 8 products, because this classification partially depends on a firm's own interpretation of what constitutes "promoting" environmental or social aspects and also because the regulators designed Article 8 as a catch-all for a wide range of funds with varying ESG aims. As such, Article 8 products currently comprise a much bigger portion of the ESG product universe than Article 9 products (approx. 89% for Article 8 and 11% for Article 9, in terms of assets).

While the Article 9 category appears more homogeneous, there are still some differences in the way the definition has been interpreted. As regulatory requirements become clearer and asset managers begin to understand the approach that peers and competitors have taken for similar funds, the current interpretation of Article 8 and 9 classification is likely to change.

It is also worth noting that the universe of sustainable funds based on Article 8 and 9 definitions is larger than the sustainable investment universe as defined by Morningstar analysts.[6] For example, only 46% of Article 8 funds fall under Morningstar's "sustainable investment" classification, as opposed to 95% of Article 9 funds. Among the ten largest Article 8 funds, Morningstar considers only one to be a sustainable investment, as seen in Figure 4.

There are two main factors behind this discrepancy. Firstly, Morningstar's definition of a "sustainable investment" is stricter than the SFDR's, excluding funds with lenient exclusion policies and funds whose integration of ESG considerations does not actually determine which investments are made. Secondly, Morningstar mostly identifies sustainable funds using fund prospectuses and key investor information documents; thus, some funds may have been missed because of poor disclosure. As disclosure improves under the SFDR, it will be possible to identify more funds that meet these criteria.

### Article 8 funds – a heterogenous group

> "Simple exclusion policies, ESG integration, best-in-class or thematic – Article 8 funds follow a wide range of approaches."

Article 8 financial products promote, "among other characteristics, environmental or social characteristics, provided that the companies in which the investments are made follow good governance practices". Quite a few asset managers have interpreted the term "promotion" to mean that sustainability must be a binding constraint in the investment selection process.

Looking at the data collected so far, most funds classified as Article 8 apply at least some exclusions. Article 8 funds typically exclude investments in companies with business activities deemed unsustainable or with high ESG risks, such as weapons, tobacco, thermal coal and other fossil fuels. They also exclude companies that violate international norms and conventions related to human rights and labour laws, such as the principles of the UN Global Compact.

Some Article 8 products promote sustainable characteristics solely by applying exclusions. This is the case for passive exclusions-only products (e.g. ESG-screened ETFs), where the exclusions form a binding constraint and are considered a core feature of the product.

However, not all Article 8 funds apply exclusions. For example, some promote environmental and/or social characteristics solely by considering material ESG factors and through engagement, with no explicit binding constraints.

> "Not all Article 8 funds have binding constraints."

Active engagement is certainly a feature common to many, if not all, Article 8 products. However, it isn't an approach that most asset managers consider sufficient to classify a product as Article 8.

[6] 4,300 funds were classified as "sustainable" by Morningstar analysts as of 20 May 2021, representing assets of €1.3 trillion, compared to around 4,000 funds classified as Article 8 or 9, representing assets of €2.3 trillion.

Many Article 8 funds also have explicit binding constraints, such as portfolio-level ESG key performance indicators (KPIs). These require that investments must achieve targets such as higher aggregate ESG scores or lower carbon intensity than a specific benchmark.

Other Article 8 funds are broad ESG funds that employ best-in-class or positive screening strategies. They seek to invest in securities from issuers demonstrating strong or improving ESG credentials.

Finally, funds with a sustainable theme such as gender diversity, climate change, and sustainable water are also included in the Article 8 category.

**Article 9 funds – "dark green"?**

Article 9 financial products have a "sustainable investment objective". These are what asset managers consider "dark green". They invest in companies with products and services that are deemed to contribute positively to environmental and social challenges, while making sure that the companies follow good governance practices and do not do any significant harm. As a result, the majority of Article 9 funds focus on a specific theme and/or impact.

> "Similar strategies have been classified as either Article 8 or Article 9."

However, strategies that look similar to those classed as Article 8 are being classed as Article 9, including thematic strategies and core ranges of sustainable funds that employ a best-in-class or positive screening approach.

This suggests that some managers may have been too strict with their approach to classification or that others have been too generous. It could also be the case that managers that have classified more funds as Article 9 are more confident than others in their ability to demonstrate the sustainable nature of their investments.

**Do Article 8 and 9 funds live up to what their managers claim?**

There are also other metrics that can be used independently of the classifications to assess whether Article 8 or 9 funds demonstrate desirable ESG characteristics. For example, how well do these funds integrate ESG factors into their investment processes and organisations? Do they have a high exposure to companies with lower ESG risk? Do they invest in companies whose activities and products are well aligned with a low-carbon economy and are associated with low carbon risk?

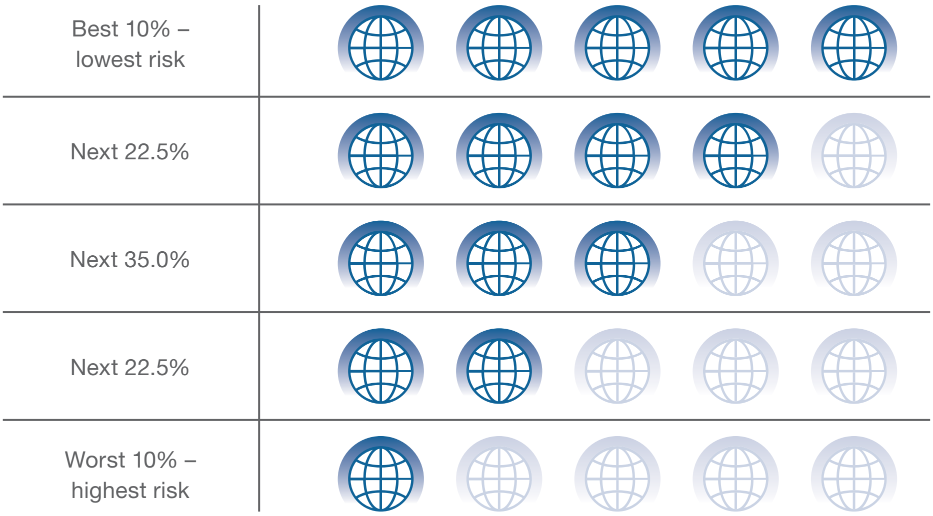
In this section, we'll compare Article 8 and 9 funds to evaluate their ESG profiles using three Morningstar metrics: the Morningstar Sustainability Rating, the Morningstar Portfolio Carbon Risk Score and the Morningstar ESG Commitment Level.

**Morningstar Sustainability Rating**

The Morningstar Sustainability Rating provides a way to evaluate how well a fund is meeting environmental, social, and corporate governance challenges relative to its peer group. It is based on underlying company ESG Risk Ratings from Sustainalytics, which measure the degree to which companies' economic value may be at risk from ESG issues. The ESG issues that are material vary across industry groups and companies.

The Morningstar Sustainability Rating is awarded to all funds in Morningstar's database, irrespective of whether they have a focus on sustainability, provided that the funds have at least two thirds of their assets covered by Sustainalytics. The rating examines every portfolio reported by a fund over the previous twelve months, with more weight given to more recent portfolios.

**Fig. 6 Morningstar Sustainability Rating – distribution of ratings**

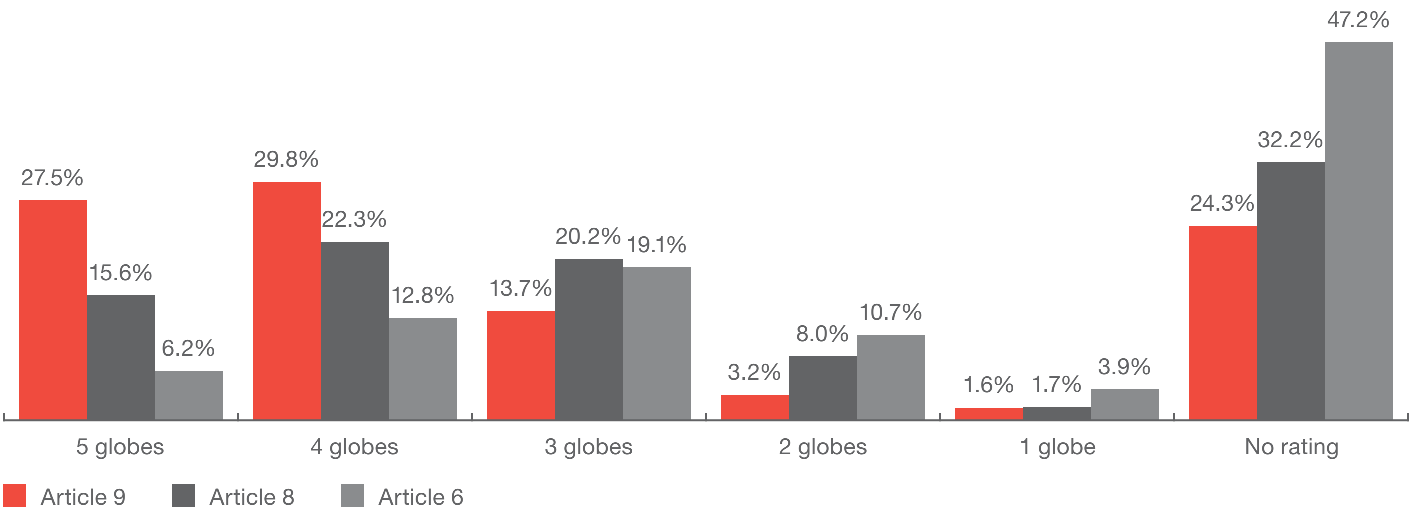



The Morningstar Sustainability Rating, also known as the Globe Rating, evaluates how much ESG risk is embedded in a fund relative to its Morningstar peer group. It is assigned on a normally distributed five-tier scale, as summarised in Figure 6.

Figure 7 shows the distribution of Morningstar Sustainability Ratings as of 31 March 2021 among Article 8 and 9 funds.

The distribution of ratings is skewed towards the higher Sustainability Ratings among Article 8 and 9 funds.

**Fig. 7 Distribution of Morningstar Sustainability Ratings among Article 8 and 9 funds**




Source: Morningstar. Data as of 20 May 2021. Morningstar Sustainability Rating as of 31 March 2021.

> "Article 8 and 9 funds tend to have higher Morningstar Sustainability Ratings."

The percentage of funds with 4 or 5 globes is highest among Article 9 funds. 57% of Article 9 funds have a Sustainability Rating of 4 or 5 globes, indicating that they invest in companies with lower ESG risks than their broad peer groups do. 38% of Article 8 funds score 4 or 5 globes; this is also a higher percentage than would be expected from the ratings distribution shown in Figure 6, in which the top 32.5% of all funds score 4 or 5 globes. However, almost 30% of Article 8 funds have a rating of only 1–3 globes. Most of these funds integrate ESG considerations into their research and portfolio decisions, but are not obliged to divest ESG "laggards" as defined by the Sustainalytics ESG Risk Rating. However, it is worth noting that a number of funds do not have a Sustainability Rating at all. Possible causes of this include insufficient coverage of portfolio holdings, as explained above.

**Morningstar Portfolio Carbon Risk Score**

To calculate the Portfolio Carbon Risk Score, Morningstar uses Sustainalytics' company carbon risk ratings, which indicate the risk that companies face from the transition to a low-carbon economy. The Carbon Risk Score goes beyond traditional carbon footprinting, taking into account management actions to mitigate a firm's carbon risk. Carbon risk ratings are the result of qualitative analysis performed by Sustainalytics analysts, who evaluate carbon intensity, fossil-fuel involvement, stranded assets exposure, mitigation strategies and green solutions. This feeds into assessing a firm's ability to manage carbon risks, and the quality of its management approach to reducing carbon risks. At least 67% of portfolio assets must have a Carbon Risk Rating from Sustainalytics before a Morningstar Portfolio Carbon Risk Score can be calculated. Lower scores are better, indicating lower carbon risk. From best to worst, the risk scores are Negligible, Low, Medium, High and Severe.

> Most but not all Article 8 and 9 funds score well on carbon risk."

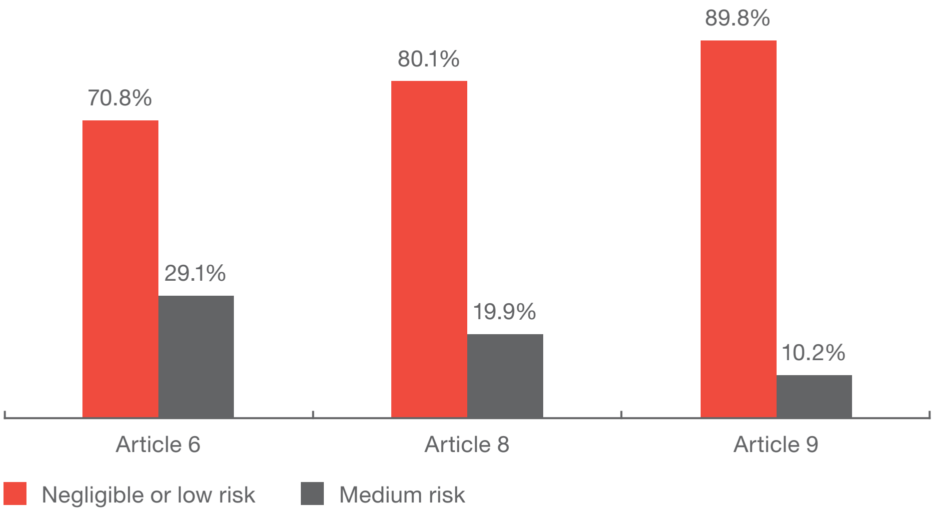
The Morningstar Portfolio Carbon Risk Score measures the risk that companies in a portfolio face from the transition to a low-carbon economy. Figure 8 shows the Morningstar Portfolio Carbon Risk Scores of Article 8 and 9 funds with sufficient portfolio coverage for a rating to be awarded.

Article 9 funds scored best on carbon risk, with 90% achieving a Negligible or Low score, followed by 80% of Article 8 funds.

This indicates that Article 8 and 9 funds typically carry less carbon risk, which will appeal to climate-conscious investors.

In 2020, Morningstar introduced a new qualitative rating issued by analysts, the Morningstar ESG Commitment Level. As of 31 April 2020, 247 strategies (representing 397 funds) and 71 asset managers have been assigned an ESG Commitment Level. Out of these, 215 funds fall within the scope of SFDR classification, and 187 funds have been reviewed by the data team; Figure 9 shows the ESG Commitment Levels for this group of funds. This group excludes passive strategies with a "Low" ESG Commitment Level, as ratings for these funds would simply replicate conventional indexes without any orientation towards ESG.

**Fig. 8 Morningstar Portfolio Carbon Risk Score of Article 8 and 9 funds**




Source: Morningstar. Data as of 20 May 2021.

### Morningstar ESG Commitment Level

The Morningstar ESG Commitment Level evaluates the extent to which asset managers and funds incorporate ESG considerations into their investment processes, and it highlights the funds and asset managers that are leading the way when it comes to ESG investing, including engagement and proxy voting activities. ESG Commitment Levels are provided for investment strategies and associated vehicles and for the asset management firms that run them. The scale runs from best to worst as follows: Leader, Advanced, Basic and Low. All strategies for which analysts produce a Morningstar Analyst Rating for Funds will ultimately be assigned an ESG Commitment Level, with analyst teams having ample discretion in determining the scope of their coverage. The qualitative rating universe is limited by the size of the analyst team; ratings are only awarded to a select number of strategies, but they are not limited to ESG-focused funds.

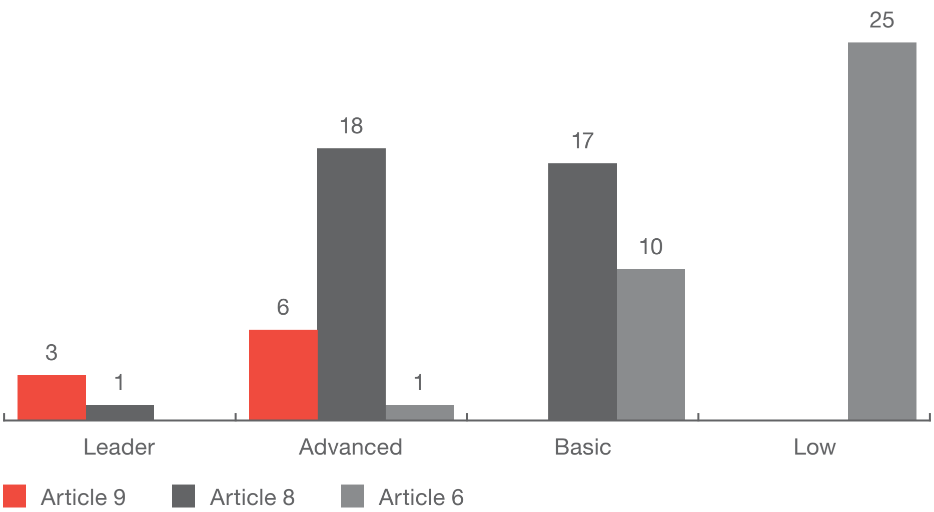
> "According to the Morningstar ESG Commitment Level, some Article 8 funds offer better ESG standards than others."

In this group of 87 funds, Article 8 funds received ratings ranging from Basic to Leader, underscoring the diverse nature of funds in this group, with some funds offering more comprehensive approaches to ESG than others.

Article 9 funds fared better, with all funds reviewed being awarded either an Advanced or Leader rating. This indicates strong ESG programmes and high ESG standards among these strategies and the asset managers that run them.

> "The universe of Article 8 and 9 funds is in a state of flux. Additional analysis is required to assess funds' ESG credentials."

**Fig. 9 Morningstar ESG Commitment Level (number of funds)**




Source: Morningstar. Data as of 20 May 2021.

## Conclusion

The range of funds for ESG-oriented investors has expanded considerably in recent years, with the SFDR further accelerating growth – both through new sustainable fund launches and by encouraging asset managers to enhance their existing offerings. However, asset managers have taken a wide variety of approaches to product classification, with some being more conservative than others. As MiFID II ESG amendments, applicable from 2 August 2022, require to consider clients' sustainability preferences in investment advice, this entails the risk for asset managers that some products classified as SFDR Art. 8 might not be suitable for clients with sustainability preferences. It is also important to keep in mind that SFDR classification is associated with certain disclosure requirements, but it does not constitute an ESG label, and additional metrics and analysis are required to assess funds' ESG credentials. As we have seen, Article 8 funds tend to have a higher sustainability profile than conventional funds – i.e. lower ESG risk and carbon risk – and Article 9 funds even more so, but this is by no means guaranteed. Investors should ensure that they understand individual funds' ESG objectives and investment processes.

The universe of Article 8 and 9 funds is very much in a state of flux, and we will continue to watch this space closely.

# 2 The next generation: consumer perspective on the current sustainable financial product offering

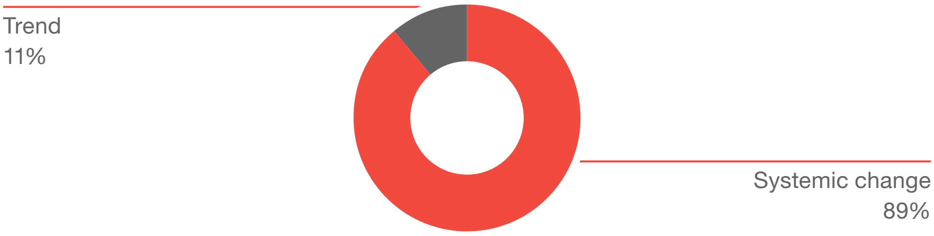
**Sustainability is becoming more important, but there are differences between generations**

Sustainability is becoming increasingly important for consumers, influencing everyone's lifestyles and consumption habits. Over the past 30 years[7], the focus has primarily been on the most tangible areas and on issues that people have the most contact with in everyday life. These include responsible use of energy and raw materials, or sustainable agriculture and agricultural products. Purchasing decisions are influenced by how companies act regarding sustainability and how they engage with society on social issues. For example, PwC's Global Consumer Insight Study 2021 found that more than 50% of consumers worldwide prefer products from companies that are committed to protecting the environment[8].

Awareness of sustainability varies between different age groups. Younger people from Generation Y (born 1981–1996) and Generation Z (1997–2012) are particularly sensitive to sustainability issues[9]. The survey conducted for this study found that while almost all of the respondents generally consider sustainability to be at least "important", 23% of Generations Y and Z said that it was "extremely important", a proportion twice as high as was the case with Generation X (1965–1980). A clear majority (89%) across all age groups agree that measures to implement sustainability represent not just a trend but a long-term systemic change (see Figure 10).

**Fig. 10 Sustainability is a systemic change rather than just a trend**

Responses to the question: In your view, is sustainability just a trend (won't catch on in the long run) or a real system change (will catch on in the long run)?



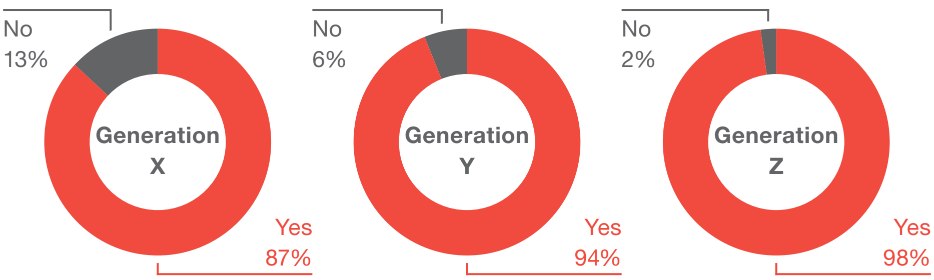

**Consumers are demanding ESG**

In many areas, an understanding and awareness of sustainability has developed in society, which is also slowly spreading to areas of life that are less tangible but no less essential. One of these areas is finance and the financial services that consumers take advantage of. Questions such as "what is my bank doing for the climate?" or "are my investments going to sustainable products?" often come up among consumers. Our survey found that over 90% of respondents believe that banks can contribute to sustainability, whether in combatting climate change or in the fight against poverty. The results again show that younger consumers have higher expectations of financial institutions than their older peers (see Figure 11).

Even more specific in terms of customer expectations is the result that a clear majority of respondents across all age groups – just under 90% – are calling for banks to contribute to achieving the 2050 climate targets. It is thus clear that financial service providers are seen as important drivers of sustainability issues with a high level of responsibility, and that they must actively participate in working towards sustainability even if these measures are more indirect in nature.

**Fig. 11 Banks can contribute to sustainability**

Do you think that a bank can contribute to sustainability (e.g. fighting poverty and climate change)?

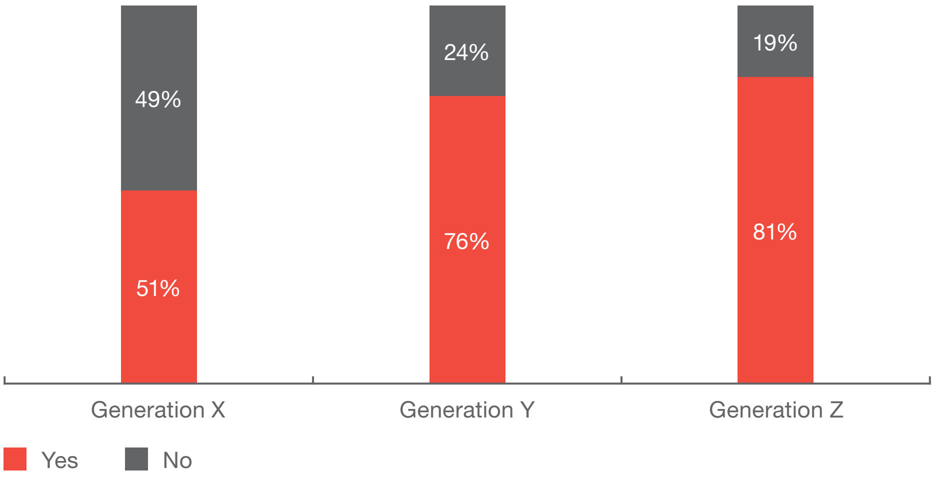



[7] https://www.are.admin.ch/are/en/home/media/publications/sustainable-development/brundtland-report.html.
[8] https://www.pwc.com/gx/en/industries/consumer-markets/consumer-insights-survey.html.
[9] https://www.un.org/youthenvoy/environment-climate-change/.

> “Two thirds of the participants are unsatisfied or very unsatisfied and feel their banks are not sufficiently committed to sustainability.”

**Fig. 12 Significant differences occur among generations, whether they would switch the bank due to lack of sustainability or not**

Would you switch to another bank if – with the same prices and services – it placed more emphasis on sustainability than your current bank?




## Customer satisfaction

Although almost 80% of the survey participants said that they were satisfied or very satisfied with the services provided by their banks, the picture is significantly different when it comes to satisfaction with sustainability. Only a third of the participants feel that their banks are sufficiently committed to sustainability, while two thirds are unsatisfied or very unsatisfied. A fundamental perceived problem is that institutions have not focused enough on addressing sustainability to date and continue to prioritise other areas.

For younger generations in particular, this would be a reason to switch providers in favour of a bank that places more emphasis on sustainability, while offering the same prices and services (see Figure 12). This result underlines other observations from the PwC Consumer Insight study – namely, that younger consumers are less loyal to companies and are more likely to switch providers if they are not satisfied with their performance and service[10].

There are two main reasons why consumers decide against switching banks: they either consider looking for a new bank and going through the administrative procedures to be too much effort, or they do not consider sustainability to be a reason drastic enough to justify switching.

However, it can be observed that customers of all generations are price sensitive and do not generally prefer sustainability over lower bank fees. For example, about one third of respondents would entrust their money to banks that have comparatively low fees even if this involves financing of companies and projects that could harm the environment and society. This shows that financial institutions cannot simply implement sustainability programmes at the financial expense of their customers; instead, they need to find a balance between additional costs and added value for all stakeholders. Parallels can be drawn with Switzerland’s $CO_2$ law which was narrowly rejected by the electorate in June 2021[11]: although a majority of people claim to be in favour of more environmental protection and sustainability, not everyone wants to run the risk of additional costs. Young voters with limited capital were particularly likely to vote against the new law because the additional $CO_2$ fees would have affected them to a greater extent. Financial institutions must take these factors into account and ensure that well-intentioned initiatives do not have a negative impact on business.

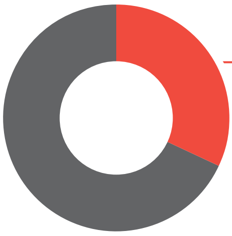
## Level of customer information

The core area in which financial service providers can influence sustainable development is by responsibly granting loans and financing for projects and ventures. Private customers participate indirectly in this mechanism through their investments in financial products. However, when asked whether they know how sustainable their financial products actually are, two thirds of respondents said they knew very little or nothing at all about the sustainability component of their investments (see Figure 13).

[10] https://www.pwc.com/gx/en/industries/consumer-markets/consumer-insights-survey.html.
[11] https://www.bk.admin.ch/ch/d/pore/va/20210613/can644.html.

**Fig. 13 The majority of customers are not sufficiently informed about the sustainability of their investments**

Are you of the opinion, that you are sufficiently informed by your bank about the sustainability of your financial products?




An important finding in this area is that a majority of consumers would be very interested in learning more about sustainability. However, this is often impossible due to a lack of available information or opportunities to obtain explanatory material, and customers feel that their banks do not provide sufficient information. Survey participants would like their banks to provide easily accessible and comprehensible information on these topics. However, it is essential that any information provided is credible. A significant proportion of respondents said that they lacked confidence in the credibility of statements made by banks on sustainability issues. Financial institutions need to respond and ensure trust through transparency to avoid the impression of “greenwashing”.

> Customers feel that they are not sufficiently informed by the banks.”

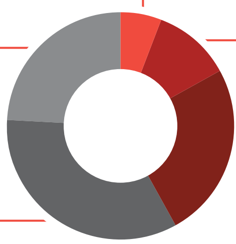
Tendencies can also be identified in the information channels and formats that customers want. For example, 81% of respondents want easy-to-follow visualisations that use charts and images to convey content in an intuitive way. Another preferred format (though less popular, at 45%) is text-based articles such as found on online blogs. Information can also be delivered through videos, but only a third of respondents want them, primarily among younger generations. As for channels, a majority of survey participants could envisage getting information directly from their online banking app or on their bank’s website. Personal appointments, emails or print media are considered less attractive.

> A clear majority of participants want at least 50% of their portfolio to be in sustainable investments.”

### Sustainable investments are gaining importance

Providing information and creating transparency with regard to sustainability is also particularly important because consumers generally want to make their investments more sustainable. The survey showed that a clear majority of participants want at least 50% of their portfolio to be in sustainable investments (see Figure 14). 24% of respondents even want to forego conventional investments altogether and focus entirely on sustainable investments.

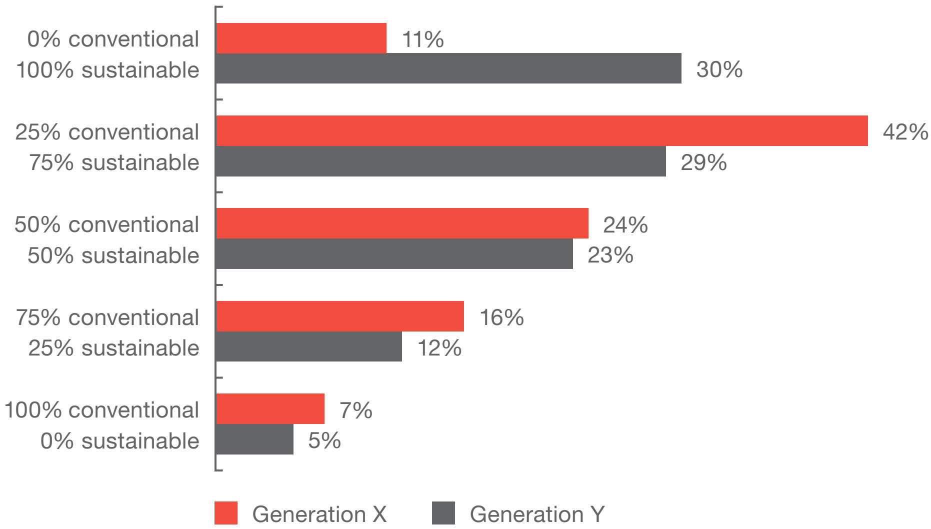
**Fig. 14 What proportion of your investments would you like to be sustainable?**



There are also clear differences between age groups in this context. While 11% of Generation X would like 100% of their capital to go into sustainable investments, the figure among Generation Y respondents is as high as 30% (see Figure 15).

Once again, it is clear that there is a need for financial institutions to take differences between generations into account. Generation Y consumers are accumulating a steadily growing share of available capital, and therefore represent the most important target group in the medium term. Special attention needs to be paid to their preferences and consumer habits.

**Fig. 15 Desired proportions of sustainable and conventional investments among different generations**




## Conclusion

More and more consumers are demanding sustainability and a positive impact from companies. This development is already well advanced in many industries, and the focus is increasingly shifting to the financial industry. Consumers believe that financial institutions can have a major influence on sustainability and expect them to actively participate in ESG activities. Although consumers of all ages are interested in sustainability issues and emphasise their importance, the younger generations (Y and Z) in particular are calling for change. It is noteworthy that a large proportion of bank customers are currently dissatisfied with the sustainability performance of their banks. In terms of investments, this is mainly due to a shortage of information and a lack of transparency about financial products. Consumers would like to know more about the sustainability criteria of their investments and to be aware of options, but the current situation does not adequately guarantee that this information will be available. This is particularly important because customers want to make their portfolios more sustainable and significantly reduce unsustainable conventional investments.

These developments mean that the financial industry must ensure greater transparency on sustainability issues and respond to consumers' changing needs.

## 3 Distributors: sustainability and its challenges for product distribution in the asset and wealth management sector

**The SFDR: distributor perspective**
Published in 2018, the EU's comprehensive Sustainable Finance Action Plan has put the asset and wealth management sector under pressure to take a close look at the new regulations in order to implement them properly. The sustainability trend is here to stay and complying with the various regulations is essential.

Level 1 of the SFDR entered into force in March 2021. At a minimum, this requires the asset and wealth management sector to classify products as Article 6, 8 or 9 and publish an initial set of product-level and corporate-level information on websites and in pre-contractual documents. At the same time, demand from private and institutional clients for sustainable financial products is increasing, opening up a sales opportunity. This makes the SFDR a great opportunity for distributors to demonstrate their commitment to offering sustainable, ESG-focused products. In addition, the Markets in Financial Instruments Directive (MiFID II) will add the consideration of sustainability preferences in suitability assessments and product governance requirements, imposing yet another requirement on the sales and distribution side.

**SFDR Level 1**
- The SFDR is addressed to financial market participants and financial advisers, as defined in Article 2
- Most of the disclosure requirements at company level and at product level took effect on 10 March 2021 (Level 1)

Disclosures at company level (company website)
- Information on integration of sustainability risks into the investment decision-making process
- Statement on adverse sustainability impacts or principal adverse impacts (PAIs)
- Information on how sustainability risks are considered in compensation policies

Disclosures at product level
- Disclosures required on the website, in periodic reports and in pre-contractual documents (e.g. sales prospectuses)
- Financial market participants are required to classify their products:
  - Article 6 product: basic product (all products which are neither Article 8 nor Article 9)
  - Article 8 product: "light green" ESG product (promotion of environmental or social characteristics)
  - Article 9 product: "dark green" ESG product (sustainable investment objective)

### Markets in Financial Instruments Directive (MiFID II) – ESG amendments

- The ESG amendments to the MiFID II Delegated Regulations entries into force 2 August 2022

### Sales obligations

- Sustainability factors must be considered when determining the target market for each financial instrument
- Distributors must ask consumers about their sustainability preferences and take these into consideration when selecting financial instruments
- Sustainability preferences must be considered in suitability assessments

### Organisational requirements

- Sustainability risks must be considered in processes, systems and internal controls
- Consumer sustainability preferences must be considered when identifying conflicts of interest

This section of the study focuses on the distributor's viewpoint, investigating how much of an influence sustainability and MiFID II are having on distributors' sales activities and looking at the current gaps from their point of view. 62% of distributors already consider themselves well informed regarding the ESG requirements under the SFDR and the planned extension of suitability assessments under MiFID II to include clients' sustainability preferences. Only 9% say they have not yet dealt with both regulatory challenges. This shows that ESG regulatory changes with a clear impact on distribution are already at top of the agenda for most distributors. Knowledge about SFDR product classifications is already widespread, and awareness of the MiFID II requirements is rising and addressing increased demand from investors.

### Expected development of Article 8 and 9 sustainable financial products

As well as being aware of the new regulations, all distributors surveyed are expecting an increase in SFDR Article 8 and 9 sustainable products: 56% of distributors are expecting a major increase (>50%) and 36% of distributors are expecting a moderate increase (10–50%) in Article 8 and 9 products over the next two years. This shows that the expected increase in sustainable products is not just a trend, but a game changer for the whole industry – which is in line with consumer perceptions as discussed in Section C.2 of this study. As a result, we expect to see new and more diversified sustainable products in the industry. This trend can also be seen in Morningstar's research as outlined in Section C.1.

### Distributor storefronts

Currently, 27% of the distributors surveyed are planning to take the strategic decision to completely discontinue the sale of conventional products that do not include any reference to ESG. This response suggests that distributors are anticipating a clear shift in consumer demand towards sustainable products, and that interest in products that include ESG considerations is being driven by increasing consumer demand as well as by regulatory change.

This strong demand from private investors was also evidenced in the consumer survey discussed in Section C.2. However, the majority of the distributors surveyed (58%) are in favour of continuing to sell Article 6 products, i.e. products without any reference to ESG. Irrespective of this result, however, it is expected that conventional (non-sustainable) investments are increasingly likely to become stranded in the long run, while climate and environmental challenges will become more material.

> "Distributors of financial products anticipate a clear shift in consumer demand towards sustainable products."

**Fig. 16 Expected development of sustainable financial products**

**56%**

expect a major increase (>50%) in Article 8 and 9 products.

**36%**

expect a moderate increase (10–50%) in Article 8 and 9 products.

**27%**

of distributors plan to completely discontinue sales of conventional products.

**Transparency on sustainability is a key success factor for sustainable product sales**
For successful sales, it is essential that consumers understand individual funds' ESG objectives and investment processes, so that they can assess how "green" the product is. 85% of distributors consider dedicated product information regarding sustainability to be essential for their current sales activities. However, when distributing Article 8 and 9 products, current product-specific sustainability information is insufficient, being limited to generic descriptions and the SFDR classification (i.e. Article 6, 8 or 9). As a result, 53% of the distributors are not satisfied with the level of detail made available by the providers of financial products (e.g. in pre-contractual documents and on websites) and with the need to request more product-specific information regarding sustainability.

> "Distributors consider dedicated product information regarding sustainability to be essential for sales activities, but more than 50% are not satisfied with the available information."

The consumer survey examined in Section C.2 also produced this result. The actual information provided is seldom sufficient to identify a detailed sustainability strategy, and there is still a large shortfall in information available to distributors. This will be addressed by the SFDR Level 2 measures: these explain in detail what form disclosures must take in future, and will require more dedicated sustainability information for Article 8 and 9 products in pre-contractual documents and periodic reports, following predefined templates. However, as Level 2 has been further postponed and is now expected to come into force mid-2022, this will prolong the information shortfall even further.

**Size of distributors' Article 8 and 9 investment advisory universes**
When looking at the composition of distributors' investment advisory universes, 30% of the distributors surveyed have more than 50% of their products classified as sustainable under SFDR Articles 8 and 9. This is rising in line with the Morningstar results outlined in Section C.1 of this study, and shows that sustainable products offered by providers are finding their way to distributors. However, as the information shortfall explained above means that there is only limited evidence available regarding sustainable investment strategy, it is very difficult to judge how well these funds actually integrate sustainability into their investment processes and organisations.

**Fig. 17 Balancing act between successful sales and dedicated product information**


**Fig. 18 Investment advisory universe of distributors according to SFDR Articles 8 and 9?[1]**

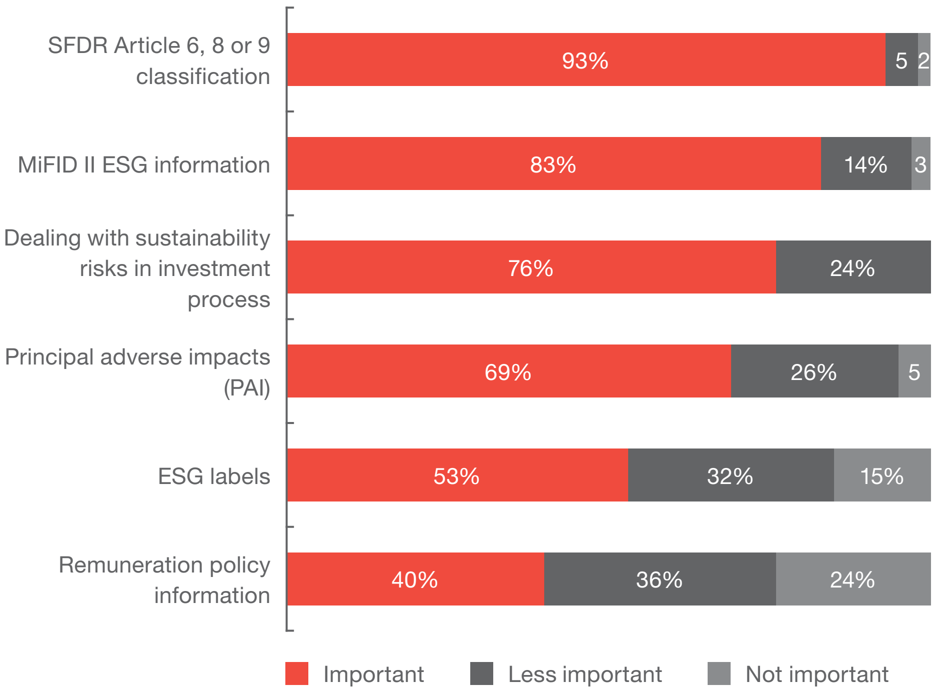

[1] Current percentage of the investment advisory universe that can be classified according to SFDR Art. 8 and 9.

### Importance of better sustainability information for distributing Article 8 and 9 products

Regarding the type of sustainability information available, 93% of the distributors surveyed consider the SFDR product classification to be the most important information for selling sustainable products, followed by MiFID II ESG target market information; this is currently being developed by industry associations and is not yet available from data providers. The MiFID II ESG amendments will enter into force 2 August 2022, and ESG target market information will then be available to distributors as part of the existing target market information. Information on remuneration policies plays a minor role for successful sales overall, but a surprisingly high proportion of distributors (40%) nonetheless consider it to be an important factor. This suggests that comprehensive information on sustainability even on company level is crucial in order to be perceived as a competent ESG focused supplier by the consumer. 54% of the distributors surveyed think that an ESG label would be important for successful product distribution. This is due to the fact that the range of ESG funds on offer is booming, and it is difficult for investors to gain an overview and identify trustworthy sustainable investment products. In addition, there are differences in the definition of "sustainability" between the SFDR, MiFID II ESG amendments and the EU Taxonomy for Sustainable Finance, which creates further uncertainty for investors when making investment decisions. The SFDR does not currently provide uniform certification or a respected ESG label, and such a label could be very helpful in guiding investors through potentially confusing offers.

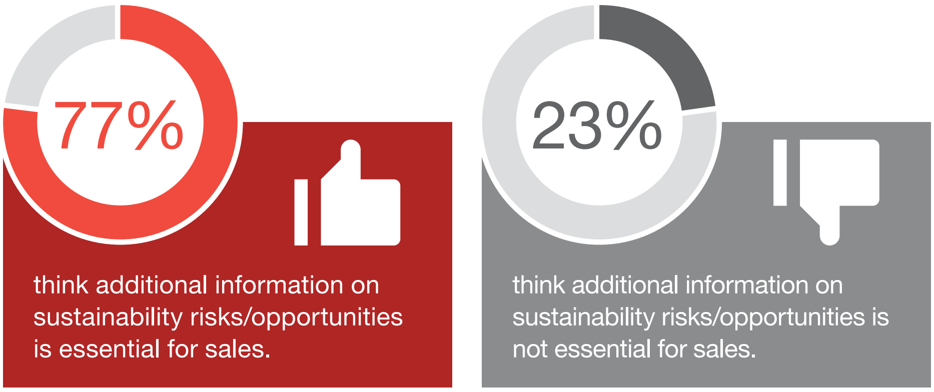
At the same time, the EU securities regulator ESMA recently announced a stronger focus on sustainable investment for the coming year and is aiming for uniform strategies across Europe against excessive ESG promises. ESMA is aiming for convergence among national supervisors and will work with them to find effective ways to combat so-called greenwashing, according to its work program for 2022.

**Fig. 19 How important do you consider the following sustainability information for the distribution of Article 8 and 9 financial products?**



Investors who are focusing on sustainable products still lack the in-depth transparency they need to make sound investment decisions. In fact, the information provided in pre-contractual documents (e.g. fund prospectuses) or on websites is very generic. Private customers have also noticed this deficit, as shown in Section C.2. There is thus an increasing need for adequate information to be provided to both distributors and investors. For the sale of sustainable products, 77% of distributors consider it essential that additional detailed information is provided on sustainability risks and opportunities and their potential impact on returns, while only 23% think this is not essential.

**Fig. 20 Is additional information on sustainability risks and opportunities and their potential impact on returns essential for sales?**



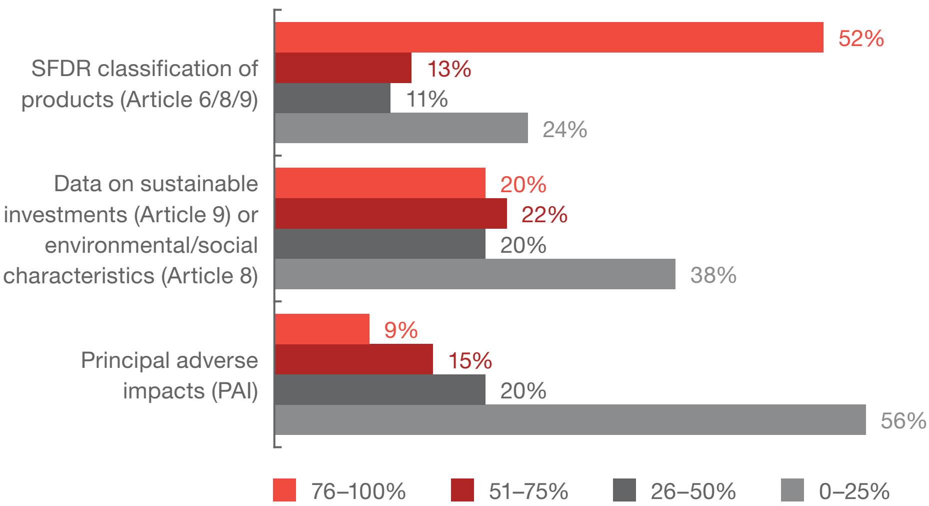

### Completeness of sustainability data categories for Article 8 and 9 products

Even though SFDR Level 1 has been in force since 10 March 2021, only 52% of distributors said that they could easily find information on websites or in fund prospectuses on the SFDR classification of the majority of Article 8 or 9 products they offer. The distributors consider this information to be crucial for their sales activities, so providers of these products need to address this shortfall. This should be achieved by further highlighting this information in pre-contractual documents and on websites, as well as by means such as providing standardised data for providers' entire product ranges.

But it's not just the product classifications that lack information. Only 20% of the distributors surveyed currently have information for most of their product range on the environmental or social characteristics of Article 8 products and on the sustainable investments of Article 9 products. It is not clear whether there is a total lack of this information or whether the respondents consider the level of detail to be insufficient. This will be further addressed by the requirements of the SFDR Level 2, which will require disclosure of dedicated sustainability information in pre-contractual documents and periodic reports, rather than generic phrases for Article 8 and 9 products.

Only 9% of the distributors surveyed have been able to obtain information on principal adverse impacts on sustainability (PAIs) for their Article 8 and 9 products. This is clearly due to the fact that, again, transparency on these impacts at financial product level is not yet required.

**Fig. 21 To what percentage of your products according to SFDR Article 8 and 9 do you currently have information on the following data categories?**

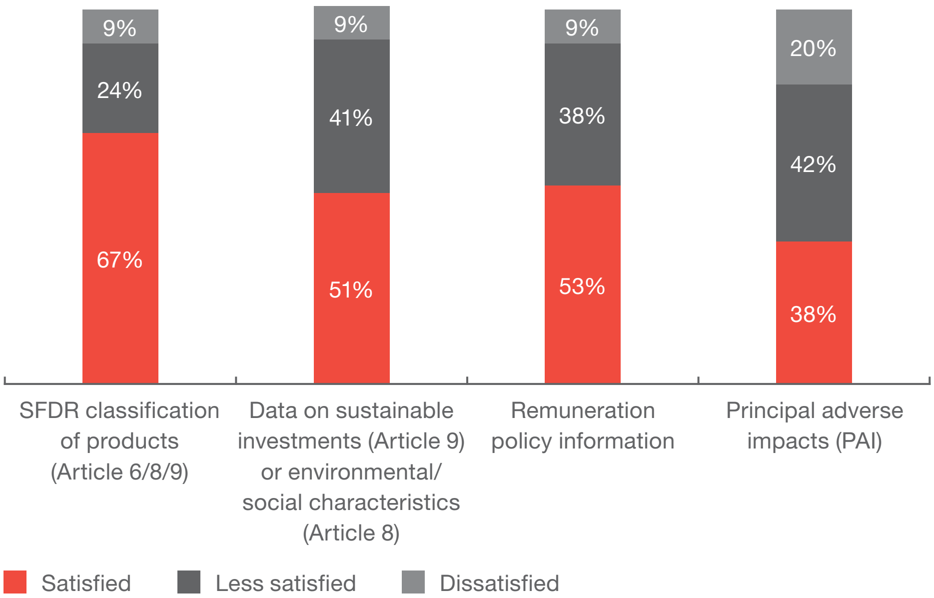


## Satisfaction with the level of detail provided by SFDR Level 1

Although 67% of distributors are satisfied with the delivery of information on SFDR product classifications, just 51% are satisfied with the information on sustainable investments (Article 9) or the environmental or social characteristics (Article 8) of these products. SFDR Level 1 does not require detailed information, and the dissatisfaction among distributors suggests that most product providers have not voluntarily disclosed detailed information. Again, SFDR Level 2 is expected to address this, but not before mid-2022.

The highest level of dissatisfaction is with the supply of principal adverse impact (PAI) information. As PAI statements at the legal entity level are available on providers' websites, this might indicate that distributors do not consider the information provided in these statements to be helpful. However, SFDR Level 2 requirements will lead to more meaningful and specific PAI reporting, at company level as well as at product level.

**Fig. 22 Satisfaction with levels of detail provided by SFDR Level 1**




## Biggest regulatory challenges

Among the distributors surveyed, 80% see availability of the data necessary to meet regulatory requirements as the biggest regulatory challenge for the next few years. This is underpinned by their concerns that they do not have enough in-depth sustainability information for their current product ranges and, therefore, will be unable to mobilise capital for meeting sustainability goals. The second-biggest challenge is ensuring a transparent investment advisory process for the consumer while implementing the complex regulatory requirements. Provision of additional individual data required by institutional clients or other local regulations took joint third place, together with dealing with the differences in the definition of sustainability between the SFDR, MiFID II and the EU Taxonomy for Sustainable Finance. Both of these issues would also help foster more sustainable products, although their role is less central than the top two challenges. The expansion of suitability assessments under MiFID II came in last place (29%), probably because there is still a lot of uncertainty on how to implement the requirements by 2 August 2022.

> Distributors name availability of data necessary to meet regulatory requirements as the biggest challenge in implementing ESG regulations."

**Sustainability information: how will providers and distributors interact in the future?**
There is a clear trend towards standardisation and away from individual solutions, as these are too costly and time consuming for the industry. When asked about how they expect product providers to deliver sustainability information (SFDR, MiFID II and EU taxonomy, if applicable) in the future, 80% of the distributors surveyed said that they would like to see a standardised format for obtaining information relevant to ESG. Around 51% believe that data providers will take on a central role as an interface, and only 27% think that individual interfaces will be needed.

**Fig. 23 Biggest regulatory challenges**

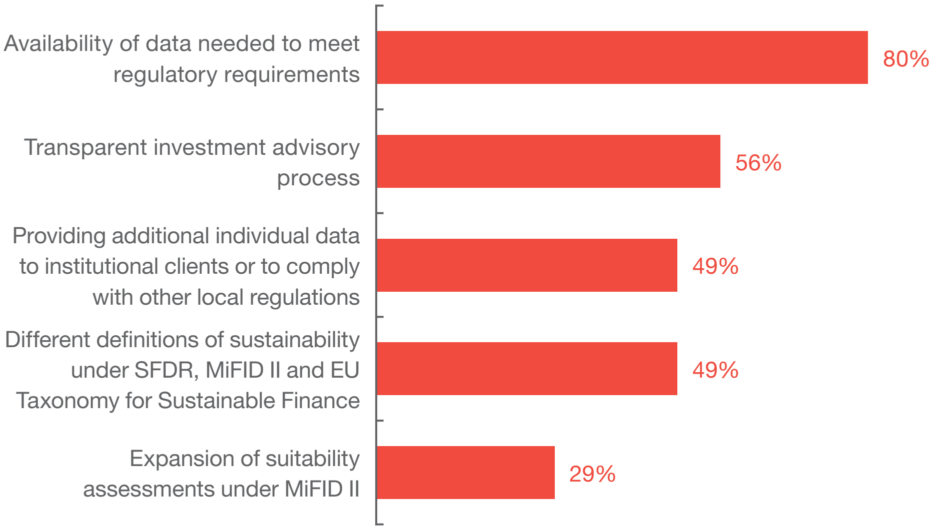
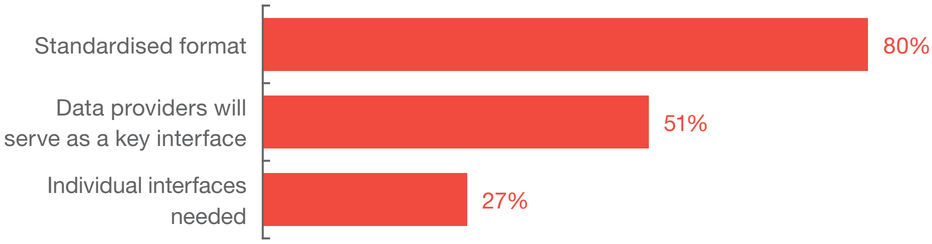



**Fig. 24 Information gathering in the future interaction model**




## Conclusion

Since the SFDR came into force in March 2021, the range of funds for ESG-oriented investors has risen sharply, but the level of information given by financial product providers about sustainable investment strategies and processes is very low and not satisfactory for distributors. This section of our study found that distributors are critical of the huge information shortfall that currently exists, as this information is crucial for successful sales of sustainable products. To understand individual funds' ESG objectives and investment processes, distributors and investors need in-depth information on product classification, risk and return, or on environmental or social characteristics for Article 8 products and on sustainable investments of Article 9 products. This information will need to be provided in more detail under SFDR Level 2, but it remains to be seen what level of detail and transparency the industry will settle on to close this gap.

For the future, distributors would prefer a standardised model for interaction with providers, with meaningful information on sustainable investments. The transition towards sustainability is only just beginning, and there is still a long way to go.

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