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Greening your financial products

A market analysis of light and dark green financial instruments in practice

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Contents

1 | Introduction

Sustainable financial products are on the rise. As investor demand is increasing, the importance of sustainably-oriented financial products is continuously growing and the rapid developments have led to a variety of environmental, social and governance (ESG) investment solutions. Financial products with different strategies, themes and ambitions offer investors the possibility to combine financial returns with sustainability considerations to a varying degree. In fact, more than $3.2 trillion were invested in sustainable products, consisting of sustainable funds, green bonds and social bonds, which have doubled between 2019 to 2021 (chart 1).[1]

Especially prominent within the sustainable fund market is Europe, where, in fact, 73% of the funds and the majority of the top ten fund issuers are located.[2] Similarly, Europe has a relatively advanced sustainability regulatory environment. Exemplary is the new EU Sustainable Finance Disclosure Regulation (SFDR) which has in practice introduced a way to classify ESG-oriented products depending on their ambition level. However, the regulatory texts leave room for different interpretations of the classifications and how to practically categorise individual products. This potentially leads to heterogenous product classification approaches on the market, with the so-called Article 8 'light green' products and Article 9 'dark green' products both exhibiting a broad spectrum of ESG strategies.

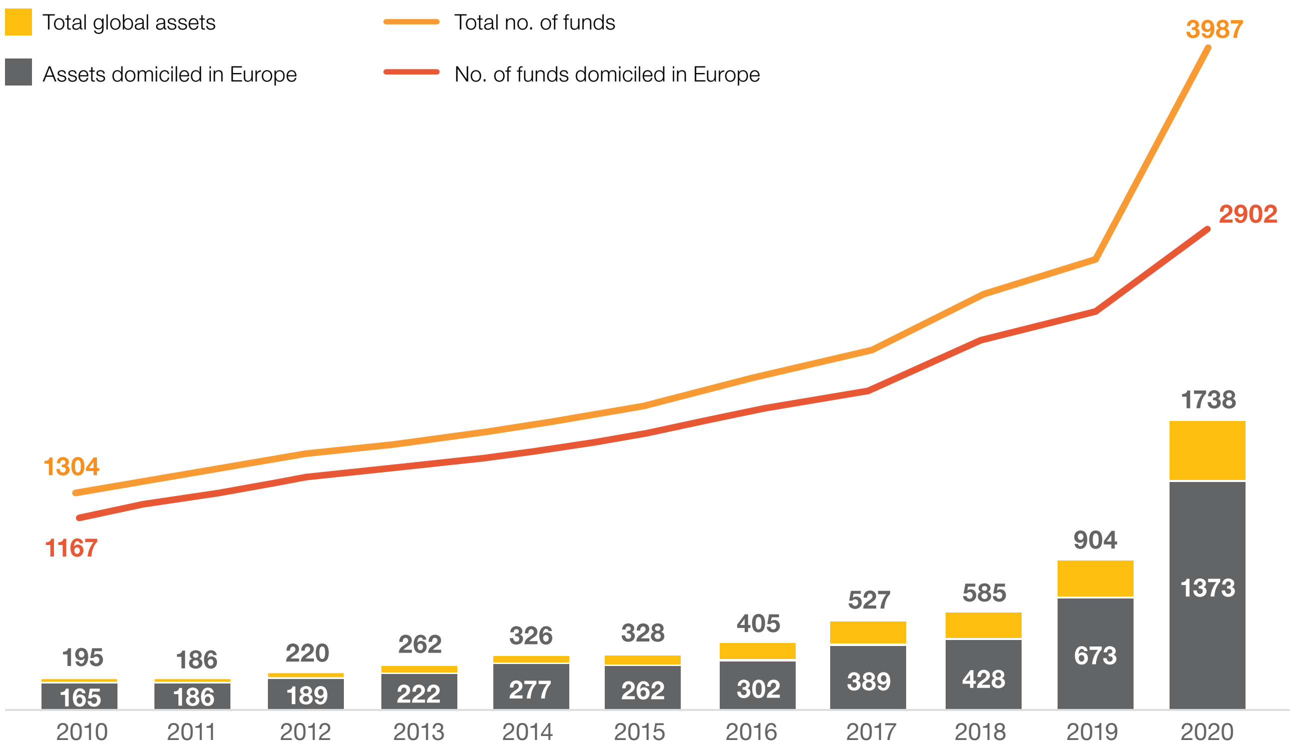
At the same time, increased regulatory obligations in the area and recent investigations by regulators around the world have brought attention to the risk of 'greenwashing' associated with greater transparency. Consequently, sustainability claims will be increasingly monitored and challenged by both investors and regulators. Rising expectations require products asserting a degree of sustainability to be able to substantiate their claims and to demonstrate how they differ from conventional investment solutions. As the area of sustainably-oriented products grows, addressing and overcoming these challenging areas will be inevitable.

This study examines the sustainability foundations and disclosures of more than 220 ESG funds distributed in Europe to identify common patterns and characteristics of ESG products, similarities and differences between Article 8 and Article 9 SFDR funds, as well as any prevailing deficiencies that could lead to greenwashing allegations.

[1] UNCTAD, 2020a; UNCTAD 2021a.

[2] UNCTAD, 2020b.

Chart 1: The sustainable fund industry: Europe dominates (number of funds and assets under management, USD billion)

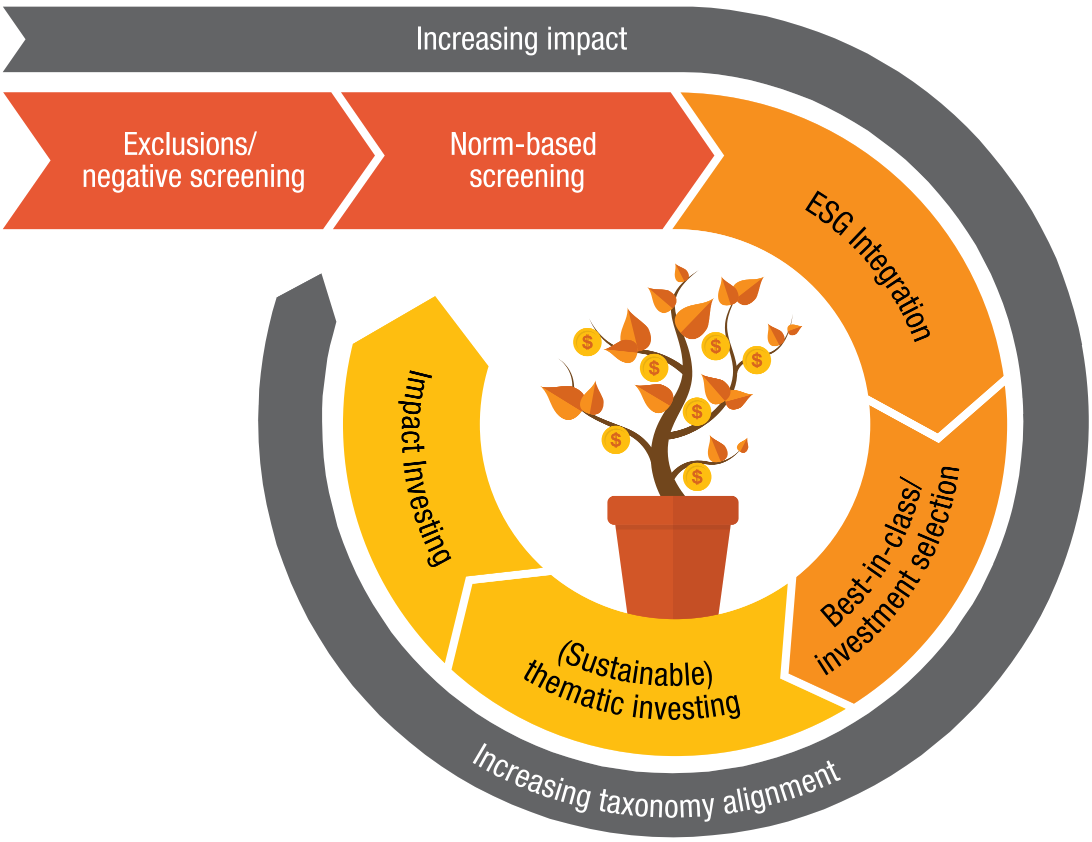


Source: UNCTAD, based on Morningstar and TrackInsight data

Note: Numbers of funds do not include funds that were liquidated; the numbers for 2020 are as of 30 June

2 | Setting the scene: regulation as the driving force

Since 10 March 2021, financial market participants and financial advisors in the EU have been subject to the reporting requirements of the Sustainable Finance Disclosure Regulation (SFDR) which is one of the cornerstones of the EU Action Plan on Sustainable Finance. With transparency being an essential aspect of sustainable investing and a perpetual concern among EU regulators, the SFDR requires that financial institutions disclose, among other things, the integration of sustainability risks and if and how they consider adverse sustainability impacts in their investment processes in a standardised way, with a view to preventing greenwashing and ensuring comparability. In addition, the EU Taxonomy and local obligations from regulators in the form of thresholds complement the SFDR and play a decisive role in the design of sustainable products with their corresponding strategies.



In particular, the SFDR introduces new obligations related to disclosures at legal entity level and for product disclosures in relation to sustainability. With the latter, the ESG disclosure requirements vary depending on the individual product's characteristics described in the SFDR. Although the SFDR is not a labelling regime, the market practice currently distinguishes between three product categories when it comes to their consideration of sustainability aspects:

1. Products that promote environmental or social characteristics, also referred to in the market as 'light green' products or **Article 8 SFDR products.**
2. Products that have a sustainable investment objective, also referred to in the market as 'dark green products' or **Article 9 SFDR products.**
3. All other products that don't qualify, also referred to in the market as 'mainstream' products or often (incorrectly)[3] Article 6 SFDR products.

In our study, we use the terms Article 8 and 'light green' interchangeably, as well as Article 9 and 'dark green', in reference to the product categories mentioned above.

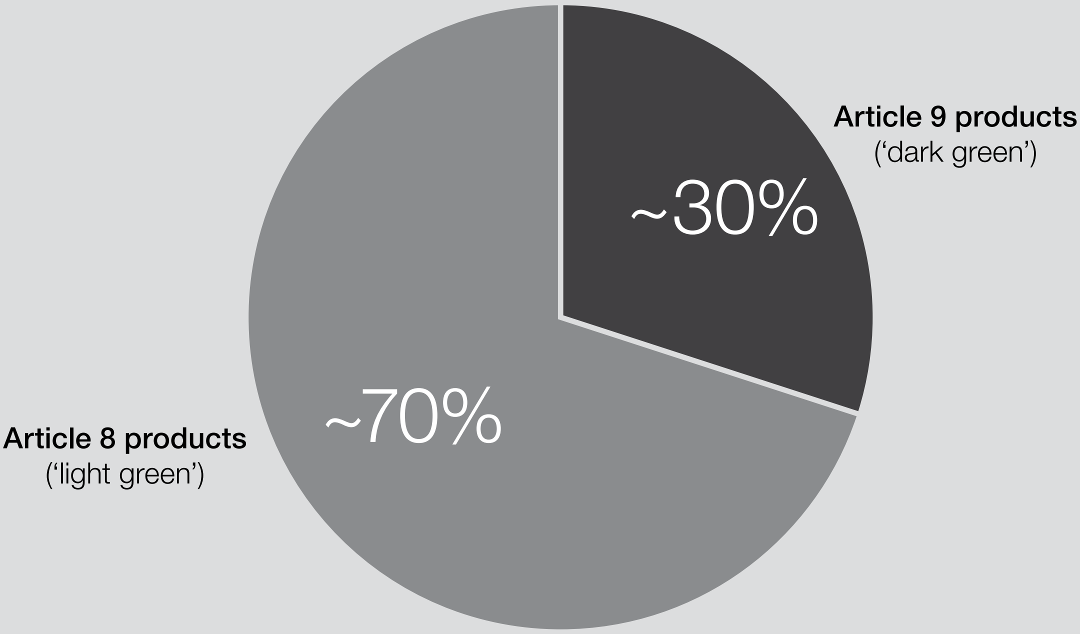
It's also worth mentioning that at this moment in time the SFDR is still not applicable in its entirety. Instead, some provisions will apply as of 1 January 2022 (periodic reporting) and 30 December 2022 (principal adverse impacts at product level). What's more, the technical specifications (regulatory technical standards) regarding the exact implementation of the SFDR obligations are expected to apply as of 1 July 2022. These specifications include prescribed detailed templates for the ESG information for Article 8 and Article 9 products.

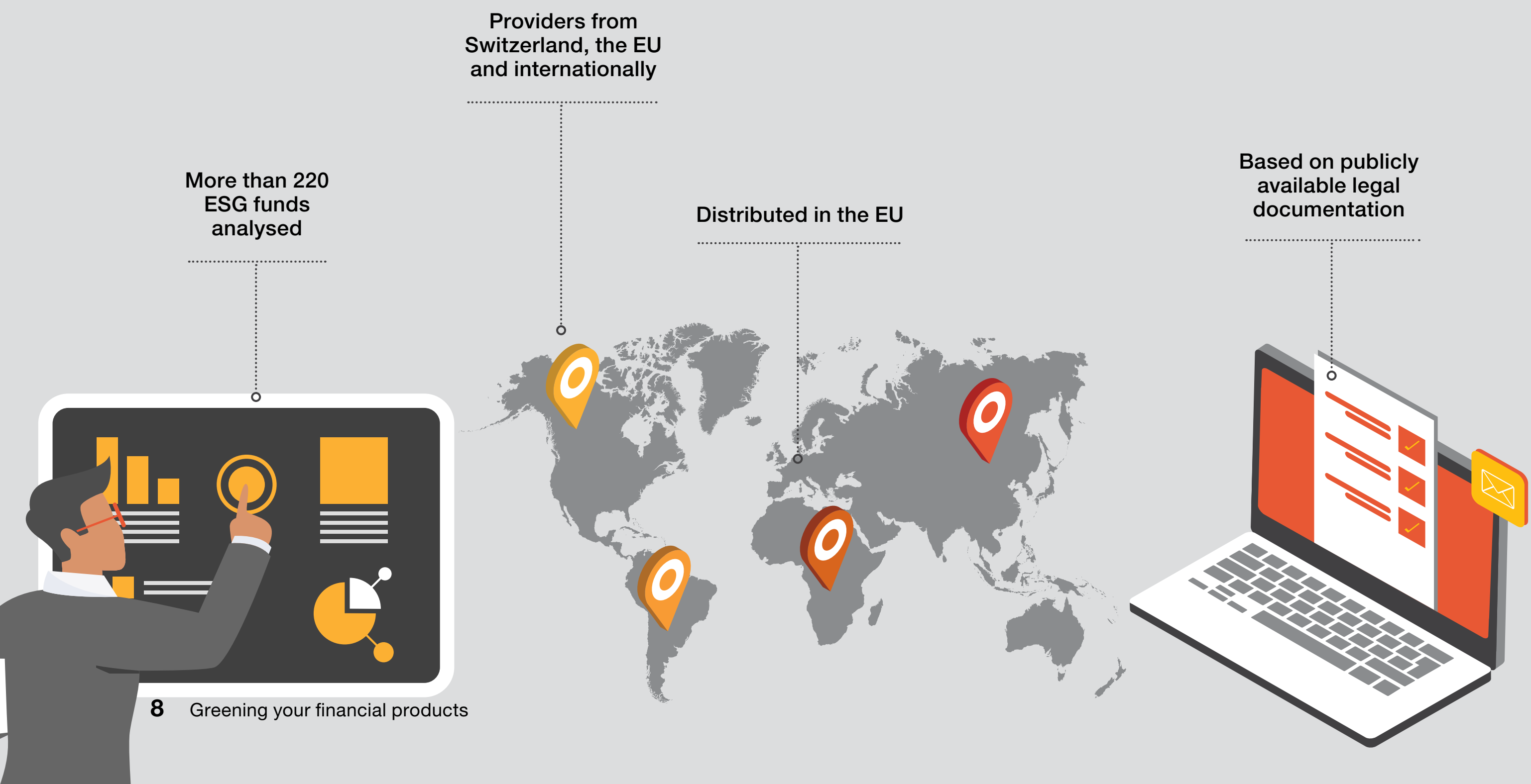
Although the SFDR and the EU currently have the strictest obligations, further jurisdictions like the UK and Switzerland have also indicated concrete expectations or increased scrutiny of ESG-related disclosures at product level.

[3] Article 6 of the SFDR requires all products, including those falling under Article 8 and Article 9 of the SFDR, to disclose information on sustainability risks. While technically Article 6 is also applicable to Article 8 and Article 9 products, Article 6 is often used in the market to refer only to the mainstream or non-ESG products that don't fall under Article 8 and Article 9.

3 | Methodology

The study is based on the investigation of a representative sample of the publicly available official documentation of more than 220 ESG-related funds distributed across the EU from 20 providers based in Switzerland, the EU and internationally. Our analysis focused primarily on the legally disclosed information in the funds' prospectuses, with complementing ESG information from factsheets and other publicly available relevant documents. As all of the funds are regulated under the SFDR, we took their SFDR categorisation as a starting point for the analysis. To be able to examine the characteristics and differences of both Article 8 and Article 9 products, our sample is composed as follows:





We examined typical characteristics of ESG-related products, also in line with the expectations of the SFDR for Article 8 and Article 9 products:

- Product name and general characteristics
- Ease of finding the ESG-related information
- Sustainability features of the fund (like ESG characteristics and the sustainable investment objective, depending on the product type)
- ESG investment strategy followed and implemented, including related aspects like methodological limits, binding elements and monitoring
- Sustainability indicators
- Information on data sources and ratings
- Adverse sustainability impacts
- References to the EU Taxonomy

The aim of the study is to examine the current disclosure practices for sustainable funds, identify common ESG characteristics, compare Article 8 and Article 9 funds, and spot potential areas for improvement.

4 | Findings

Summary

Our findings can be broken down into four different key areas: ESG product elements, ESG disclosure, ESG data and ratings and ESG investment strategies.

ESG product elements	ESG disclosure	ESG data and ratings	ESG investment strategies

1. ESG product elements

Typical characteristics of ESG funds

- Strong focus on light green products within the market
- Equity funds form by far the largest component (around 70%), followed by bonds
- Actively managed portfolios outnumber those that are passively managed in both product categories
- Most funds apply exclusions in combination with other ESG investment strategies
- Similar ESG investment strategies between light green and dark green products

Particularities of light green funds

- The term 'ESG' is only found in Article 8 fund names in the sample
- Three out of four products follow a broad-themed ESG approach without specifying the concise and concrete ESG characteristics, e.g. "the fund seeks to promote environmental or social characteristics by integrating ESG criteria in the investment process"

Particularities of dark green funds

- The term 'Impact' is solely to be found in Article 9 fund names in the sample
- Often have more concrete sustainable investment objectives, mostly related to climate topics (e.g. low-carbon, clean tech)
- More thematic and impact investing compared with light green products

2. ESG disclosure

Overall major disclosure deficiencies

- Disclosures are often too general, vague and superficial
- No, or weakened, ESG binding elements or KPIs in the majority of the sample, mainly as a result of the use of open-ended wording
- More than 1/3 of the products do not indicate a minimum asset allocation to ESG investments
- Little critical reflection on methodologies, mostly no, or little, information on controls and monitoring of ESG elements
- Disclosures are often unstructured and not always easy to find – difficult and time-consuming to understand which rules apply to which (sub-)funds in the case of umbrella structures

3. ESG data and ratings

- Almost all institutions in scope rely on external data and rating providers, mostly MSCI and Sustainalytics
- Only about 30% provide information about third-party ESG research providers used
- Merely 1 out of 3 products discloses the use of internal ratings

4. ESG investment strategies

Confusion around terms

- General inconsistencies regarding the meaning of different investment strategies varying from bank to bank but also within the documentation of the same financial institution
- In different context, the term 'ESG integration' may refer to:
  - general consideration of ESG aspects in the investment process
  - a separate investment strategy based on bottom-up research
  - own product categories ('ESG integrated')

Questionable impact

- Investment strategies often combine different approaches that are not necessarily well suited to achieving a true impact as crucial elements are missing
- Many products merely aim at having a better sustainability performance than their oftentimes non-ESG-related benchmarks
- The vast majority of products do not set specific thresholds, or set them very low, for example in best-in class approaches
- ESG research/criteria are often applied to significantly less than 100% of the portfolio

Details of our analysis

Number of Article 8 vs. Article 9 products

While composing our sample, it quickly became apparent that Article 8 products are currently more prevalent on the market compared to Article 9 products. For the purpose of the report, we've deliberately tried to include sufficient Article 9 products in our sample, so as to give a representative analysis of that category. But it should be noted that the market has a stronger focus on financial products considering ESG characteristics to varying extents (Article 8), whereas impact-oriented products still remain the exception. This is consistent with findings from other studies.[4]

Product name

The different degrees of sustainability consideration are in some cases reflected in the naming of the funds. The term ESG is only found in the name of Article 8 funds in our sample, whereas 'impact' is reserved for Article 9 fund names. There are no such differences in relation to 'sustainable'; this term features in the names of Article 8 and Article 9 funds. Another common pattern is the inclusion of the main ESG thematic terms or topics, like 'low carbon', 'circular economy', 'SDG', 'green bonds', 'blue' and similar. Almost all Article 9 funds in the sample include some kind of ESG-related wording in their name. On the other hand, not all ESG funds include the main ESG terms in their name, especially Article 8 products.

Asset class

Certain differences between light and dark green products can be expected in relation to the **funds' asset classes,** as some might be more suitable for generating impact (e.g. private equity) than others (listed equity). In our sample, equity funds (around 70%) form by far the largest group, followed by bonds (around 20%). Our investigation doesn't indicate an asset class differentiation according to the ESG product – equity is the most popular asset class for both Article 8 and Article 9 products – nor does it reveal any substantial distinctions regarding the selection of the asset class.

Ease of finding the ESG-related information

Our analysis showed significant differences regarding where the ESG-related information is published in official documents like prospectuses. In the case of umbrella structures, information is often scattered between the general part and the individual sections of the sub-funds with multiple cross-references. While this might seem like a more efficient approach at first, especially where one ESG approach is applicable to several sub-funds, it's often difficult and time-consuming to understand which rules apply exactly to the particular sub-fund and whether any specifics or exemptions exist. This is especially important regarding the ESG approach taken and the ESG measurement. Bearing in mind that often references are also made to documents outside the prospectus (e.g. policies on the website), which can be very confusing for the potential investors, in particular in umbrella structures containing light green, dark green and non-ESG sub-funds. Such challenges are expected to be addressed at least partially with the introduction of the mandatory SFDR templates containing the technical specifications. More targeted ESG information is often additionally published in factsheets.

Active vs. passive products

Another aspect of interest is whether the funds are being **actively or passively managed**. In our sample, we found both types of portfolio management for light and dark green products, with actively managed funds being by far the largest group in both product categories. While it's less surprising to find passively managed or index funds among Article 8 products, the question arises as to whether passively managed funds can, by definition, qualify as Article 9 products. The SFDR doesn't exclude this option, as long as the reference index meets the requirements for dark green products. As a result, the reference indices we found for passively managed Article 9 funds were different to those for Article 8 funds. But whether the reference indices are deemed to be suitable for Article 8 or Article 9 funds often remains unclear, as no reference to the SFDR is made regarding the benchmark itself. Examples of reference indices can be found in the table below.

Examples of ESG reference indices for passively managed Article 8 and Article 9 funds

Reference indices for Article 8 funds	Reference indices for Article 9 funds
• Bloomberg Barclays MSCI Euro Corp SRI • Sustainable Ex Fossil Fuel 1-3Y Index • ECPI Global ESG Blue Economy Index • BNP Paribas Growth Europe ESG Index • JPM ESG EMBI Global Diversified Composite Index • MSCI Emerging Markets ESG Leaders Index	• FTSE EPRA Nareit Developed Europe ex UK Green EU CTB index • Low Carbon 100 Europe PAB® index • Euronext Low Carbon 300 World PAB Index • MSCI Japan Climate Paris Aligned Index • MSCI EMU Climate Paris Aligned Index

4 See section 5 for more information.

ESG characteristics, objectives and themes

Generally, we observed that broad-themed funds dedicated to 'sustainability' or 'ESG' contribution – including SDG-aligned funds – are by far the most popular (about 60% of the sample). In the case of more thematically focused funds, we noted a predominance of climate or GHG-related topics. By contrast, other sustainability subjects remain heavily underrepresented, as is the case with biodiversity, land use or inclusion, for example.

A broad approach for the ESG characteristics descriptions can be observed for **light green products.** Three-quarters of the sample didn't specify the concise and concrete ESG characteristics applied to Article 8 funds, which can partially be explained by the fact that Article 8 funds often promote a variety of environmental and social characteristics at once without focusing on a specific theme.

But many funds provide rather vague descriptions and few examples of what such characteristics can constitute, leaving investors potentially confused. In several cases, we observed that the promoted environmental or social characteristics are simply described through the applied investment strategies, especially through the sectors or activities excluded, without concretising the characteristics further. Common examples include:

The fund seeks to promote environmental or social characteristics by:

- integrating ESG criteria in the investment process
- employing ESG safeguards
- following an ESG integration approach.

If specific environmental or social characteristics are provided, they refer mainly to climate/carbon/energy and relationships with people.

Conversely, the sustainable investment objectives of **Article 9 funds** tend to be described more concretely compared to the environmental or social characteristics of Article 8 funds, being again mainly related to climate topics, including the reduction of greenhouse gas emissions, net-zero and low-carbon emissions, clean tech and energy. Other objectives include further environmental themes, such as water and forestry, as well as social themes, like health and nutrition. We also found funds with a mixed objective, pursuing both environmental and social impact at the same time, e.g. funds related to urbanisation and mobility.

ESG strategy

When taking a closer look at what's at the core of ESG products – the ESG investment strategy – we found that nearly every product, be it light or dark green, applies investment exclusions or limitations, often as a first step before applying further ESG approaches. This corresponds also with the latest study conducted by Morningstar.[5] Most of the **exclusions or restrictions** refer to controversial weapons, fossil fuel-related activities (coal, oil sands), controversial activities like alcohol, tobacco, adult entertainment and gambling as well as certain countries and international sanctions, and the breaches of norms ('controversial behaviour'), mostly of the UN Global Compact. Rare exclusion criteria include activities related to palm oil, world heritage sites or genetically-modified organisms, to name just a few. Overall, the depth of exclusion approaches varies considerably. Whereas some exclusions are formulated rather superficially, others provide more details and specific thresholds for exclusion. Special emphasis should be placed on exclusion policies that differentiate between product types in terms of sustainability. In the latter case, three sets of exclusion criteria are usually applied: (i) a basic set or 'blacklist' of exclusion criteria for all products, (ii) additional exclusion criteria for products that are deemed more sustainable or 'responsible' and (iii) even more additional criteria for sustainable or impact funds. The three categories are not necessarily equivalent to the SFDR categorisation but reflect the nuances of sustainability consideration, which could be a reasonable approach.

[5] See section 5 for more information.

Simple approach to exclusions

Differentiated approach to exclusions

What's more, in several cases, the excluded sectors were listed in the fund description regardless of the thematic focus of the funds, i.e. certain funds wouldn't have invested in these activities anyway. This means the exclusion policy might have a higher impact on some products than on others, which isn't necessarily highlighted for the specific products. Besides, some funds don't indicate details or thresholds regarding investment restrictions, which as a result could imply literally anything:

The fund manager **intends to limit** investments in companies within the oil and gas sector.

The exclusion is then often followed by **other ESG approaches,** ranging from ESG integration, best-in-class and engagement, to thematic and impact investing. As expected, thematic and impact investing are more often applied for dark green products than for light green products, whereas the other investment approaches are equally employed in both cases.

As regards **thematic and impact investing,** the increased application of these strategies for dark green products may have its roots in the nature of this product type, which is more objective – and impact-driven than that of Article 8 products. Funds with a thematic investing approach can be identified either implicitly through their sustainability features (e.g. specific thematic sustainable investment objective) or explicitly when sustainability-themed investing is mentioned as one of the fund's investment approaches. This type of fund is particularly suitable for investigating what actually differentiates light from dark green products, as both product categories would address the same topic and so may exhibit similar ESG characteristics. Our analysis indicates that financial institutions may have followed very different approaches in the SFDR categorisation, resulting in products with similar elements being either categorised as light green or dark green products. It's also evident that the disclosure in the prospectus isn't yet sufficient to highlight major differences in such cases.

Case example: comparison of healthcare funds

During the analysis, two healthcare funds from different providers in the sample – one Article 8 fund and one Article 9 fund – were compared based on the disclosed information in the prospectus, with the purpose of identifying differences in the approaches based on the classification. The comparison showed significant similarities in the depth of the ESG-related information, the ESG approaches and how they are described. Based solely on the disclosed information in the prospectus, there was no significant correlation between the classification and the ESG-related elements. This example indicates that different providers may have taken different approaches in the classification of their products.

Interestingly, the Article 8 fund provided a relatively strict and clear definition of what it considers to be sustainable healthcare, a minimum asset allocation expressed as a percentage and some binding quantitative elements for the selection of the investee companies' universe. The Article 9 fund description on the other hand, was less precise in comparison, describing a broader perception of sustainable healthcare with less quantitative indicators around the ESG strategy. The ESG investment approach of the Article 8 fund was based on the analysis of the identified companies by building a tailored healthcare score, while the Article 9 fund based its ESG strategy on the investment universe of a reference index, which was then refined by considering ESG factors. Both funds also applied additional exclusion criteria, with the Article 8 fund even mentioning concrete healthcare-specific exclusion criteria.

When **best-in-class** approaches are applied, they are – again for almost all products in our sample – described rather generally and in a non-binding way. General explanations of the strategy are provided but without mentioning any further specifications on how it's applied by the organisation and, most importantly, where the selection threshold is set. Descriptions often refer to:

- ESG leaders
- best issuers
- companies among the leaders in their peer group.

So as to understand the full impact of the investment strategy on the investment universe and to capture its sustainability implications, this information is essential. Only one financial institution in our sample mentioned for a few of its products that applying the best-in-class approach will result in a concrete reduction of the global investment universe expressed as a minimum percentage.

When investigating ESG investment strategies, it's worth noting that there are certain **inconsistencies regarding the terms used**, which might cause confusion among end consumers. For example, 'negative screening' is sometimes being used as a synonym for 'exclusions'; 'exclusions' sometimes include 'norm-based screening', whereas in other cases both terms are being used separately; 'positive screening' sometimes refers to a 'best-in-class' approach; 'ESG integration' is used in parallel to 'ESG inclusion'.

Strong confusion arises with use of the term **'ESG integration'**, which, based on our observations, conveys a variety of meanings as outlined below. These meanings not only vary from bank to bank, but also within the documentation of the same financial institution. In addition, the disorientation increases even more when related terms come into play, like 'ESG inclusion' or 'ESG incorporation'. It's highly questionable as to whether end consumers and investors are able to navigate through this jungle of similar terms and fully understand their meanings in different contexts.

All in all, we see **no fundamental differences between light and dark green funds as regards the choice of ESG investment strategies,** which, viewed in isolation, can be considered a neutral observation as several investment strategies are, theoretically, equally suited for both product categories. But, when it comes to concretising this strategy, more substantial information and clearer answers would be expected to core questions regarding Article 9 funds – how is the objective of the fund, which has sustainability at its core, being attained? How is progress measured? What is the real-world impact of the investments? While Article 8 funds often promote a broad set of ESG characteristics, Article 9 funds pursue a more precise objective and so would also need even stronger, binding elements that underpin the sustainability substance of the product.

Meaning 1: ESG integration referring to the general consideration of ESG aspects in the investment process

1

ESG integration used to describe that ESG factors are integrated as part of the investment process. Example: the sustainability objectives of the strategies vary depending on the specific degree of ESG integration in each investment strategy.

Meaning 2: ESG integration referring to a separate investment strategy based on bottom-up research

2

ESG integration as a separate ESG strategy. Example: the ESG investment strategy includes integrating material ESG factors into the investment analysis and decision-making by using ESG research as part of the due diligence process in order to understand non-financial risks and opportunities.

Meaning 3: ESG integration referring to a company's own product category

3

ESG integrated funds referring to 'mainstream' non-ESG products that include investments under the consideration of ESG factors as an additional layer, e.g. through basic exclusions. ESG factors in this context often relate to sustainability risks and principal adverse impacts on sustainability factors.

Use of ratings

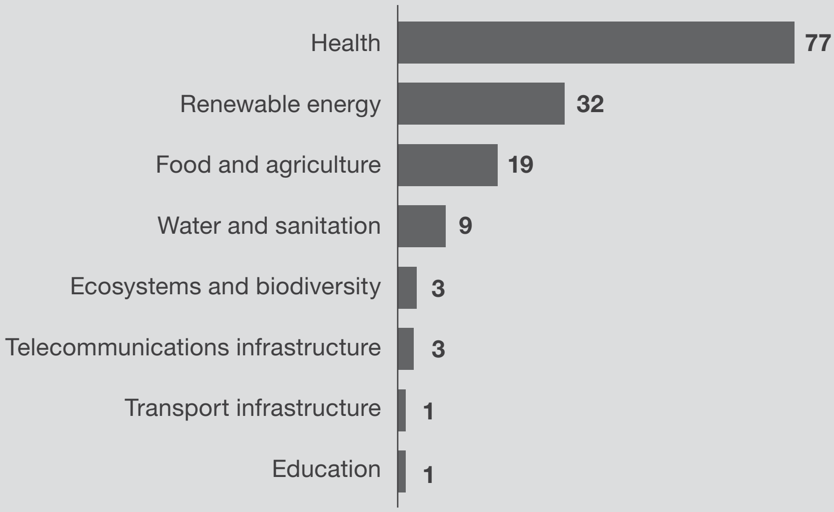
To assess the sustainability characteristics and performance of the portfolio constituents, almost all financial institutions in our sample build on external data and rating providers. But, to truly understand and get a full picture of the investee companies, the use and development of internal rating methodologies or scores can be considered useful, if not indispensable, especially for Article 9 products. By contrast, we find that internal ratings are only used for about one-third of the sample products. Here, no specific patterns as regards the use of these internal ratings for light or dark green products can be identified – the disclosures reveal that sometimes internal rating methodologies are applied to all funds of a financial institution, sometimes only to some of their light green and sometimes to all of their dark green products. In many cases, the proprietary rating methodology is merely described superficially in the product documentation, without giving concrete explanations on how it works and how it differs from external, more generic sustainability ratings or scores. Often, it's also not clear which proportion of the portfolio is subject to the internal ratings, or, in the worst case, whether it's applied to the specific product at all.

With regards to SDG impact, very rarely, specialised internal rating methodologies are being developed to measure and report the contribution to the SDGs.

The contribution of sustainable funds to the UN's Sustainable Development Goals (SDGs)

Challenges remain with respect to measuring SDG alignment of investment funds, including a lack of SDG company data and no clear definition of what constitutes an SDG investment or contribution. At the same time, according to an UNCTAD study investigating more than 800 sustainable funds, these funds committed on average 27% of their assets to eight key SDG sectors. This underscores their critical importance in filling the SDG financing gap (chart 2).

Chart 2: Investment in eight key SDG sectors (deployed assets by sustainable funds, 2020, USD billion)



Source: UNCTAD, based on data provided by Conser.

ESG assets as a percentage of total assets

Another indicator for the sustainability degree of funds is the minimum proportion of assets allocated to ESG products. More than one-third of the products don't indicate this figure and another third disclose a minimum asset allocation between 60–70%. Around one-sixth indicate a number of 75% or more, but these are often very vaguely defined and potentially misleading by using wording like: min. 90% of the assets have an ESG score (potentially implying that a less favourable ESG score might be included).

Transparency of the ESG strategy's binding elements

In general, sustainability disclosures are rarely tailored to the specific (sub-)funds, but generic text blocks are used instead, which are very repetitive and at the expense of credibility. This goes hand in hand with the fact that sustainability disclosures often lack specificity, like which are the binding elements for the investment selection. In about 80% of the sample, the prospectuses suggest no or weakened specific binding elements, mainly through the use of open wording (like the strategy can be executed through xyz, the rating is a first guidance, the fund may look into certain KPIs).

Percentage of excluded investments based on the ESG strategy

Similarly, a minimum targeted percentage to reduce the investable universe as a result of applying the ESG investment strategy is seldom mentioned. Two-thirds of our sample don't specify any targeted excluded percentage. When disclosed, the minimum thresholds mostly lie at around 20%. It remains questionable as to whether this is really sufficient to deem a fund sustainable or ESG compliant.

ESG measurement and KPIs

The lack of specificity is also reflected in the absence of specific ESG indicators to measure the attainment of the sustainable investment objective or the environmental/social characteristics, which are not provided in 90% of the funds' prospectuses from the sample. When disclosed, these indicators mainly refer to 'carbon footprint' or 'carbon intensity'.

The same applies in relation to specific ESG KPIs for the purpose of applying the ESG investment strategy. The disclosures often lack concrete quantitative indicators and thresholds of what exactly is assessed, and they rely on more qualitative, descriptive information.

More often than not, no concrete examples are provided in the prospectus. In many cases, the phrasing is rather vague. For instance:

- **The fund evaluates material sustainability risks and opportunities (without further specification).**
- **The fund considers the issuer's contribution to the SDGs.**
- **The fund invests in companies that are leaders in sustainable topic A / invests in companies expected to benefit from sustainable topic B.**

More quantitative information can be found in the factsheets or dedicated accompanying sustainability documents. Examples for ESG KPIs that often feature in the factsheets include:

- average ESG rating (external or internal) of the fund's portfolio
- various ESG scores including breakdowns per sector or distribution of the ESG rating within the portfolio
- number of controversies or controversy score
- GHG/carbon-related metrics of the portfolio, like carbon footprint and carbon intensity
- ESG KPIs or scores of the top investments
- comparison of the ESG KPIs used for the fund vs. those of the benchmark

Yet, in this context it should be mentioned that while ESG-related KPIs in the factsheets and other documents are without doubt important for investors, they serve different purposes than the information in the prospectus. While they are usually backward-looking and relate to the current and historical ESG performance of the fund, the prospectus is the central legally binding document describing the targeted ESG approach, which should be accompanied by appropriate quantitative indicators.

In many cases, the ESG performance is measured through referring to a mainstream benchmark. In a typical situation, a superior ESG performance to the benchmark is targeted after excluding the benchmark's worst 20% of companies in terms of ESG scores. In fewer cases, a specific ESG benchmark is used or none at all. Most dedicated ESG benchmarks are used for passively managed funds.

Limitations of the ESG methodology

Another important step to prevent greenwashing is the critical reflection and disclosure of methodological shortcomings of the ESG fund, i.e. any limitations of the ESG approach and how these are being handled. In more than half of the cases, no methodological limits were mentioned (around 60% of the sample) and, overall, we found very few critical reflections. Most methodological limits refer to:

- limited data availability, coverage and quality
- dependence on third-party data providers and indices
- subjectivity and potentially incorrect application of ESG criteria by the investment manager
- non-ESG investments being partly included in the funds (in some cases this is accompanied with more explanations or a justification, like possible use of derivatives for hedging or cash for liquidity reasons)

Where present, the limitations are mostly in the form of disclaimers and lack details on how the fund manager is addressing them.

ESG data

Transparency of the ESG data sources is still developing. Cited data sources often include publicly available corporate data like company reports and sustainability reports, NGO reports, expert networks and ESG data published by third-party vendors. While the vast majority of the funds in the sample disclose that external ESG research providers are being used or may be used, most of them don't provide further specifics. Only about 30% of the sample provides some concrete information about the third-party ESG research providers being used. Common external data providers cited include MSCI, Sustainalytics and Bloomberg, sometimes in combination with other specific databases like the Roundtable on Sustainable Palm Oil (RSPO).

Transparency of monitoring and compliance

In more than half of the cases (57% of the sample), no statements are made regarding monitoring and continuous implementation of the ESG strategy. One-quarter of the disclosures mention that monitoring is taking place but don't specify in any way how the monitoring or review is conducted:

- compliance is monitored at all times
- the approach requires appropriate monitoring in on-going risk management and portfolio monitoring.

Investors are virtually provided with no information about whether and how the disclosed ESG strategy is effectively monitored. This raises doubts as to whether the ESG aspects and sustainability performance of the funds are being sufficiently tracked in practice.

Adverse sustainability impacts and DNSH

The vast majority of the funds (around 85%) does not yet explicitly indicate any adverse sustainability impacts that the product may generate or make any references to the concepts of Principal Adverse Impacts (PAI) or Do No Significant Harm (DNSH) in the prospectuses. Almost all funds that actually include information on adverse impacts do so in a rather general way by merely providing a general statement. Explanations on how the DNSH or PAI assessments are conducted or what led to the estimation that the fund is considered to do no significant harm are missing. Some funds indicate that adverse impacts are taken into account through the underlying investment strategy, e.g. ESG integration or exclusions.

Examples include:

- All holdings within these funds will be deemed to do no significant harm to environmental or social factors according to an internal assessment methodology.
- The sustainable investment does not significantly harm the sustainable investment objectives.
- To align the fund with the 'do not significantly harm' principles, it integrates ESG aspects along the investment process.
- The principal adverse impacts on sustainability factors are considered through the exclusion list.

References to the EU Taxonomy

Besides a few references to the Do No Significant Harm principle which originates from the EU Taxonomy, the latter does not play any role in the SFDR disclosures yet, neither for light nor for dark green products. Only a handful of funds in our sample do explicitly refer to the EU Taxonomy with general statements that the underlying economic activities are assessed as to how they contribute to the environmental and/or social objectives of the EU Taxonomy. However, no further information on the assessment methodology or results is provided. As the EU Taxonomy is not yet applicable and the official social Taxonomy objectives do not yet exist on a regulatory level, the substance of such statements remains unclear.

In more than half of the cases, no statements are made regarding monitoring and continuous implementation of the ESG strategy.

5 | Our findings in the context of other work in the area

Our investigation has led to findings that are largely consistent with those of other studies and work conducted in this area. In the following, we'd like to highlight the most important overlaps.

UNCTAD studies on sustainable finance

UNCTAD has been monitoring the latest developments in sustainable finance and assessing the sustainability credentials of sustainable funds. UNCTAD's 2021 World Investment report (UNCTAD, 2021a) included a dedicated chapter on sustainable finance that analysed the latest trends in sustainable fund and bond markets as well as the role of market institutions such as stock exchanges and regulators. Two other recent studies, one focused on sustainable mutual funds (UNCTAD, 2021b), the other on exchange-traded funds (ETFs) (UNCTAD, 2021c), mapped the current landscape for the global sustainable fund and ETF market. The reports found that although sustainable funds as a group tend to outperform the benchmark in terms of sustainability, there was a wide variation in their sustainability performance, and underperforming funds may not meet their sustainability credentials.

European Sustainable Investment Funds Study 2021

The European Sustainable Investment Funds Study 2021, commissioned by the Association of the Luxembourg Fund Industry (ALFI), found similar results for sustainable funds in general, independently of their SFDR categorisation.[6] This includes universal fund characteristics such as equity being by far the most important asset class of sustainable funds, in the same way that actively managed funds clearly outweigh passively managed funds. At the same time, they note that most sustainable funds have relatively less ambitious ESG strategies and impact funds remain the exception.

Impact-related publications

There are plenty of further studies and academic publications analysing – and questioning – the true impact of sustainable investments, like 'Doing Good or Feeling Good? Detecting Greenwashing in Climate Investing' – a study by EDHEC which concludes that many of the analysed funds aren't managed in a manner that's consistent with the communicated impact.[7] Additionally, Busch et al. state in their study 'Impact investments: a call for (re)orientation' that the term 'impact investments' is often simply used as a new framing for sustainability-related investment practices. As impact by no means simply means ESG, the authors also call for a more transparent definition of sustainable investment products like impact investments, as well as further disclosure of their impact through their investment-induced change in the real world, for example.[8]

Report by the Dutch Authority for the Financial Markets (AFM)

A recent report by the Dutch financial market authority, the AFM, urges Dutch investment managers to increase the transparency and quality of their SFDR disclosures, which often lack concrete descriptions of their sustainable characteristics and objectives and how these are going to be attained through the investment policy.[9] The AFM further questions much of the sustainability classification for funds given that numerous Article 9 funds do not seem to focus exclusively on sustainable investments. Moreover, it states that many disclosures do not sufficiently describe how sustainability risks are integrated into the investment policy and what their likely impact on returns will be.

Morningstar studies

Since 10 March 2021, Morningstar has compiled two studies dedicated to SFDR funds: the first one was 20 days after the SFDR applicability date and the second was four months after the date.[10] In its recent publication, Morningstar detected similar product patterns for Article 8 and Article 9 products, just as we did, like the predominance of light green products and actively managed funds, as well as the prevalence of exclusion approaches often being combined with other investment strategies. What's more, Morningstar also didn't identify any significant differences in investment strategies for light and dark green products. As regards the sustainability topics covered by both product categories, Morningstar found mainly broad ESG funds among Article 8 products, whereas Article 9 products tend to include more funds and companies with a focused objective, like those that 'provide positive solutions to the world's biggest challenges like climate change',[11] which is in line with our findings.

6 ALFI, 2021.
7 EDHEC Business School, 2021.
8 Busch et al. 2021.
9 AFM, 2021.
10 Morningstar, 2021a and Morningstar, 2021b.
11 Morningstar, 2021b, p. 26

Greenpeace reports

Greenpeace Switzerland and Luxembourg have published two reports in 2021 on the topic of sustainable funds with similar findings to ours. The report 'Sustainability Funds Hardly Direct Capital Towards Sustainability', published in May, conducted a statistical evaluation of over 75 retail funds.[12] The results showed that the analysed sustainable funds hardly channel any capital towards sustainable economic activities. In addition, the results suggest that these funds are only effective in divesting from companies involved in major environmental controversies, but not concerning the impact improvement of climate and sustainable portfolios. Among other reasons, the NGO also points towards the lack of transparency of sustainable funds concerning clear investment rules, measurable impact-related goals and the actual portfolio impact.

As part of another study in August – 'Climate mystery shopping at Swiss banks' – Greenpeace Switzerland sent mystery shoppers to 19 Swiss banks to test them on climate-friendly investments, finding that the majority of products offered to them were only marginally more climate-friendly than traditional ones.[13] In this context, the NGO highlights inadequate – or at least inadequately described – investment strategies which often combine different approaches but aren't suitable for generating true (climate) impact. This means many products merely aim at having better sustainability performance than their benchmarks or use best-in-class approaches to eliminate only the worst companies per sector from the investment universe. What's more, it notes that ESG criteria are often not applied to the entire portfolio. Similar to our conclusions, there's a lack of transparency and vague formulations in product documentation, making it hard for end consumers to understand why certain products are deemed to be more sustainable than others.

[12] Greenpeace, 2021b.
[13] Greenpeace, 2021a.

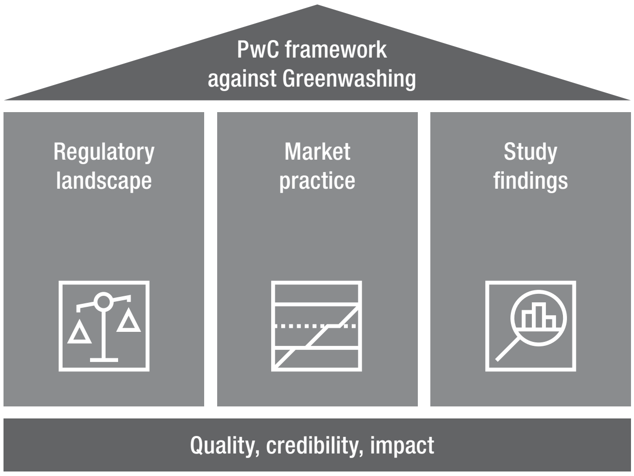
6 | Outlook

Conclusion against the background of regulatory developments

In line with previous studies conducted by a variety of organisations, our study has led to the conclusion that current sustainability disclosures for funds aren't yet serving their purpose, which is to provide transparency and prevent greenwashing. The disclosures largely lack completeness, quality and comparability, even when considering that some provisions aren't yet applicable from a regulatory perspective.

Although this speaks for itself, further regulatory developments put even more pressure on financial institutions to reassess their so-called sustainable product shelf and current disclosure practices. Apart from the SFDR provisions becoming applicable in 2022, in an attempt to prevent the risks of greenwashing and protect investors, several national regulatory bodies are adopting guidelines to regulate the information provided to investors to evaluate the approaches underlying sustainable investment funds. France already published its policy in 2020 and is following the overarching principle that the objectives associated with the consideration of non-financial criteria must be measurable.[14] For instance, for a 'selectivity' approach, the investment universe must be reduced by at least 20% so as to make non-financial characteristics a major aspect of communication (e.g. in its name). Whereas Germany, which is currently undergoing legislative processes to adopt national guidelines, is considering a minimum investment of 75% in sustainable assets or a sustainable fund strategy like a 'best-in-class' approach to be granted the right to refer to product sustainability in such a way.[15] As a result, rapid changes within the regulation of sustainable investment products don't end with European regulatory initiatives, but involve a growing body of national regulations as well. But, even at European level, a trend towards minimum standards can be observed.

Beyond that, European sustainable finance regulation comprises much more than the SFDR. In particular, the EU Taxonomy and MiFID II ESG amendments, which will also become applicable next year, will have a significant impact on both the disclosure and greenness of products. On the one hand, the EU Taxonomy will require the exposition of portfolios' investments in defined sustainable activities, whereas MiFID II will let customers express their sustainability preferences by default, which can be met through three types of financial products: those with a certain proportion of taxonomy investments or of sustainable investments according to the SFDR, or those that consider certain principal adverse impacts. By then at the latest, there'll be no more room for excuses and vagueness.



Finally, growing regulatory expectations, along with recent investigations and increasing litigation in relation to ESG matters should get the financial sector's attention. Efforts to prevent greenwashing and substantiate ESG claims should be a top priority for every financial institution in order to match investors' expectations and to avoid reputational damage and potential sanctions, but also to seize the business opportunities. So, to address these challenges, PwC has designed a framework and a dedicated questionnaire for developing credible sustainable products, ensuring sufficient transparency and setting up effective monitoring and controls for the implementation of the ESG strategy. Our approach is based on our analysis and expertise, the various regulatory expectations and best market practices. We support our clients in their ESG transformation by helping them in every aspect, from the initial ESG product design to the disclosure of ESG elements.

[14] AMF, 2020.

[15] BaFin, 2021.

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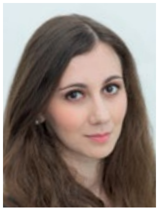

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