THE IMPACTS OF SUSTAINABLE FINANCE DISCLOSURE REGULATION ON THE EUROPEAN DISTRIBUTION LANDSCAPE

February 2021

INTRODUCTION

> "We want to be leaders in the ESG space and we want to do this with integrity."
>
> **Julian Ide, Head of EMEA Distribution, Franklin Templeton**

Investors will see important changes in the way their asset managers provide sustainability-related information on their products and updated sustainability policies. This is the result of requirements emanating from the European Union's (EU) Sustainable Finance Disclosure Regulation (SFDR) which are broad in scope, impacting not only asset managers but also other financial market participants including the likes of insurers, pension providers, as well as qualifying venture capital and social entrepreneurship managers.

The Regulation is about more transparency and authenticity for our clients—eliminating examples of 'greenwashing' or those products where sustainability is not truly embedded into processes.

We believe the implementation of SFDR will be a game changer and will have a fundamental impact across the financial services industry. The EU's action plan will enable asset managers to become more connected with our clients in our shared commitment to invest and allocate capital sustainably, to achieve better outcomes for all.

WHAT ARE THE IMPLICATIONS?

In recent years, the demand for environmental, social and corporate governance (ESG) products from investors has grown quite rapidly with no signs of slowing down. Investors increasingly want products that better reflect their values and beliefs, and therefore have a positive impact on our world, while also delivering sustainable financial returns.

Why do we have this Regulation?

The Regulation is part of a much larger framework, which is the EU's action plan on financing sustainable growth[1], originally adopted in 2018 and has an overall aim to connect finance with sustainability. The action plan, in turn is the response to two important global developments: first, the United Nations' 2030 Agenda for Sustainable Development, which set out the Sustainable Development Goals and second, to fulfil the EU's commitment to the United Nations Framework Convention on Climate Change, better known as the Paris Agreement.

How does the Regulation fit into the overall action plan on sustainable finance?

The action plan has three clear objectives, 1) to reorient capital flows towards a more sustainable economy, 2) to mainstream sustainability into risk management, and 3) to foster transparency and long-termism.

SFDR keyfacts

- First set of disclosure required by 10 March 2021.
- Firm level disclosures are required to describe our sustainability approach.
- All products to be categorised as article 6, 8 or 9.

SFDR articles

Article 6
Integrate sustainability risks into advice or portfolio management investment decisions.

Article 8
Products which actively promote environmental or social characteristics.

Article 9
Products which have sustainable investment as their objective.

We see value in all three categories of disclosures to allow us to serve different client objectives.

However, the significant growth in investor demand and subsequent response from asset managers has created a crowded environment, which makes it harder for investors to assess ESG credentials of funds and the asset managers who create those products.

What does this mean for the European distribution landscape?

Any flexible ESG integration approaches are off the table. Analysing sustainability risks as part of the overall risk management framework is integral to building portfolios which deliver long-term sustainable financial returns. Reporting will be required across the three article categories.

According to a study by PricewaterhouseCoopers (PwC), 77% of institutional investors will stop purchasing non-ESG products within the next 24 months[2] and by 2025, €7.6 trillion will be invested in ESG products—that is an increase from 15% today to 57% market share of European assets.[3] In our view, whilst the speed of transition will depend on several factors, including public and political pressure and further regulation, the direction of travel is clear to see.

This means that the industry will not be able to simply highlight in their material that a product is sustainable, they need to show that this has been considered at the outset.

> "While the SFDR represents more reporting, it also creates verifiable requirements for sustainability claims. We welcome these standards as they will empower investors to align their investment decisions more effectively with their values and their want for a more sustainable future."
>
> **John Levy, Director of Impact, Franklin Real Asset Advisors**

Providers will need to disclose information at a **firm-level**, their sustainability policies and additionally, they will also be required to disclose information on a **product-level** about their financial products. In both cases, the consideration of principal adverse impacts (PAI) of investment decisions on sustainability factors need to be disclosed.

In addition to the regulatory push, the global pandemic COVID-19 has been a contributing factor towards catapulting and accelerating the world further toward sustainable investing. Both institutional and retail investor interest in ESG continues to grow apace and has arguably accelerated dramatically as a direct result of the ongoing COVID-19 crisis. With competition for investor capital expected to ramp up, managers cannot afford to ignore client demands for greater transparency around how they take ESG factors into account.

At Franklin Templeton, we've been meeting the majority of these requirements for many years by placing emphasis on transparency and authenticity. We believe that over time, the European distribution landscape will shift decisively towards sustainability-oriented products as standard.

We want to be leaders in the ESG space, and we want to do this with integrity. We don't want to just comply with the new Regulation—we are holding our investment teams to a higher level because we believe in it and remain fully committed.

This will also be reinforced by the amendments to the MiFID II delegated act, which is currently in draft, but has stated that clients indicating sustainability preferences should be offered 'sustainable investment' products, which would mean **article 8** or **article 9** products.

What does this mean for investors?

The real economy is shifting, and consumers are looking for more sustainable choices. Take the energy sector as an example where renewable energy previously was not available. Now 'green energy' has become an option that is widely acceptable with providers—energy that has been produced in a sustainable and environmentally friendly manner.

A research study by Franklin Templeton in the United Kingdom revealed how strongly younger workplace pensions savers feel about 'responsible investment'. Up to 78% feel their current pension provision does not align with their values, or do not know if it does. Importantly, 45% of respondents would be motivated to increase their contributions if their pension incorporated responsible investment values.[4]

> "I think that SFDR is a key step in driving forward transparency and authenticity in how investors approach ESG and sustainability. Having integrated ESG into our investment approach for over a decade we welcome this development."
>
> **David Sheasby, Head of Stewardship and ESG, Martin Currie**

Investors want their provider to become more motivated in telling investors how they are integrating ESG factors into their business strategies and identifying new products which puts sustainability at the top of their requirements.

With the advent of increased sustainability-related disclosures being made available in the public domain, which should be published on websites, this should provide investors with verifiable requirements for sustainability claims.

OUR COMMITMENT TO ESG

Franklin Templeton is focused on meeting the primary legislations (Level 1 requirements), which has meant a great deal of work and collaboration behind the scenes. Importantly, the work will not end in March 2021. In accordance with Franklin Templeton's strong commitment to ESG and sustainability, we will continue to review our investing solutions to transition more and more of our products to become more sustainability-oriented.

"We appreciate the efforts of the Commission to further clarify and define the different approaches to ESG investing for clients throughout Europe. We expect the new system to help identify the level to which investment managers incorporate ESG into their security selection"

MaryJane McQuillen, Head of ESG and Portfolio Manager, ClearBridge Investments

With the recent integration of several specialist investment managers into the Franklin Templeton family, we are very fortunate to be able to offer a diversity of ESG approaches from Brandywine Global, ClearBridge Investments and Martin Currie. Each of these managers have full autonomy over their investment processes and offer their own unique approach to responding to the disclosure requirements of the Regulation.

As a global investment manager with a rich history of over 70 years as a fiduciary, Franklin Templeton is committed to supporting and strengthening the consideration of ESG opportunities and risks across our entire platform.

SUMMARY

The Regulation will be a game changer and will transform the playing field for the financial industry enabling more transparency and authenticity for our clients and will give more sustainable investment choices for investors. At Franklin Templeton, we don't want to just comply with the Regulation; we want to be leaders and do this with integrity.

"Our business will become an ESG dominated business."

Julian Ide, Head of EMEA Distribution, Franklin Templeton

We recognise there is still much to be done. The work required to be fully aligned to the EU's ambitions demands a multi-year effort. We will continue to evolve in this direction, because we believe this is what our clients deserve.

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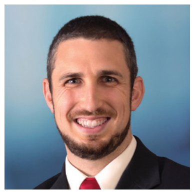

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Franklin Real Asset Advisors

Endnotes

1. European Commission Action Plan: Financing Sustainable Growth.
2. Source: PwC, 2022—The growth opportunity of the century, 2020.
3. Ibid.
4. Source: Franklin Templeton, Adoreboard. The Power of Emotions, Responsible Investment as a Motivator for Generation DC.

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