THE DAILY CHECK-IN WITH GOLDMAN SACHS
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Liz Bowyer: Hi Evan.

Evan Tylenda: Hi Liz.

Liz Bowyer: You and your colleagues at Goldman Sachs Research have written about the changing nature of ESG regulation in Europe, coming off the first phase of the SFDR, or Sustainable Finance Disclosure Regulation. What is the SFDR? And why is it so significant?

Evan Tylenda: Yeah, so the SFDR is really, you know, for the first time across a region is legislation released aiming to standardize the details disclosed by asset managers for how they integrate ESG into their investment process and address what the regulation calls principal adverse impact, or simply ESG risks within their investment decision making process.

You know, there are two disclosures here. There's one at the firm level. And then also at the product level. And one of the key requirements of SFDR is that investment funds will be required to be classified as ESG or non-ESG, which will then carry additional reporting requirements.

So, I would say prior to this, classifying ESG funds was a bit of a free for all in many ways, or a bit like the Wild West. And so, SFDR, the aim is really to rein that in and provide more structure around how asset managers make ESG disclosures available to the end investor.

Liz Bowyer: And what kinds of implications does SFDR have for investors in Europe and globally?

Evan Tylenda: Yeah. So, SFDR will apply to all financial products sold into or created in Europe. It would require them to classify themselves as ESG or non-ESG. And this is, frankly, leading to the mandating of ESG integration, I often say. Because we're seeing enormous pressure being placed on asset managers to begin classifying more and more of their AUM as ESG for one reason or another. We've already seen the many asset managers come out and say that 100 percent of their financial products are ESG. While others are as low as 1 percent.

Now, some firms have actually taken a fairly conservative view. You know, some have said that 20 percent of their funds are labeled as ESG. But have set targets at the end of the year to get to north of 80 percent. And so, for us the direction of travel is quite clear here as more and more AUM starts to move towards ESG, that will carry additional reporting requirements. And many predict that non-ESG funds will find it quite to market themselves within Europe.

Liz Bowyer: And how are asset managers actually going about the process of labeling their funds with ESG?

Evan Tylenda: Within SFDR there are really two ESG labels. One called article 8, which is light green. And then another called article 9, which is deep green. And frankly, right now, investors are kind of struggling with how to think through, you know, what type of fund or strategy goes into each of those classifications.

But what we've seen from some of our research in looking at some of the international prospectuses that have been released around SFDR is that generally article 8 funds, or light green funds, tend to be funds that are integrating ESG into the investment process. So, they're looking at data. They're weaving that into the investment decision making process. Article 8 says that the funds simply promote environmental and social considerations within the investments.

There are then additional exclusions. There are stewardship engagement strategies that can be kind of added onto an article 8 fund to, I think, make it much more credible. And frankly, what we're seeing is there's a wide spectrum of interpretations of what can be an article 8 fund.

Article 9 is a little bit more straightforward where the language in the regulation says this is a fund that explicitly targets environmental and social considerations. So, what many people are classifying there are funds that are very impact oriented, thematic in nature, linked to the sustainable development goals or even the taxonomy to some extent.

Liz Bowyer: So, on the taxonomy, there's a big focus on the EU sustainable taxonomy. How is that linked to the SFDR?

Evan Tylenda: Yeah, so really, the two are interwoven. SFDR is the classification system that requires funds to be labeled as article 8 and article 9. Once those funds have been labeled as article 8 or 9 ESG funds, they will then have to report the proportion of their investments invested in taxonomy aligned activities.

Liz Bowyer: So, what is the taxonomy?

Evan Tylenda: So, simply, the taxonomy is the tool established by the European Commission to define which economic activities are either green or not. And right now, they've defined 90 activities within climate change mitigation and adaptation. So, the taxonomy right now covers obvious activities that are green such as renewable energy production, renewable energy equipment manufacturers, hydrogen fuel cell producers, battery storage, et cetera. But also, has made room for heavier industries that need to transition and decarbonize. So, you could think of steel, cement as potential examples there.

Liz Bowyer: So, taking cement as an example, how would the taxonomy work there?

Evan Tylenda: Yeah, so within cement, right now what they've set out are, you know, thresholds, carbon thresholds that, if met, cement companies can claim that their revenue is green. So, right now if you produce cement below a certain carbon threshold per ton of cement produced, you can therefore claim that cement as green. You know, companies will then be required to report their revenue, their capex or their opex that is aligned to those taxonomy activities where those thresholds are met.

So, the ultimate goal here with all of this is to provide transparency, both from the companies and from, ultimately, the end investors to really help facilitate the flow of capital towards the most sustainable outcomes.

Liz Bowyer: So, this an approach developed for the EU. But how are other countries thinking about their own taxonomies?

Evan Tylenda: That's a great question. So, right now the EU taxonomy is the most advanced taxonomy currently developed. You know? However, we are seeing international taxonomies being proposed. For example, Canada, China, Singapore, and even the UK are looking to establish their own versions of the taxonomy. Now, because the EU version is the most advanced, you know, there is going to be some coordination taking place. And right now, the International Platform on Sustainable Finance is really tasked with coordinating all of these international taxonomies to ensure that there's not overlap and duplication of many of the criteria set in the EU version.

Liz Bowyer: So, finally Evan, Europe is clearly leading the way when it comes to ESG regulation. But what are some of the challenges that you see there?

Evan Tylenda: Yeah, so absolutely, Europe is leading the way on the ESG front. But the regulation is not without challenges. And so, I'd highlight three key things. The first and obvious one is data. Much of the data required under both SFDR and the taxonomy just simply does not exist yet from companies. So, what, as part of this, the EU Commission is also going to be requiring companies to report under the taxonomy, these are large companies which does not yet include smaller companies. And that is one issue that currently exists.

In addition to that, this obviously applies only to European companies. So, non-European companies that don't fall under the requirements will not be reporting their alignment to the taxonomy, which will be a challenge for global investors that will have to make a determination around companies in their portfolios for how they will fit into to taxonomy. So, we need some guidance on how far, you know, data, models, estimates can go when investors make their own determination.

And the second point I would highlight is this will be a significant burden initially that will certainly subside over time. So, you know, just being cautious that European companies are not placed at a disadvantage with international peers given that they're going to have to be following these additional requirements.

And then lastly, I think just as important to make the point that this regulation should not be seen as a crutch to both companies and investors in which to view ESG or green investments through as the sole lens. Because as we know the science and innovation is constantly evolving. And you know, therefore we want to make sure that the market is flexible in the way that they apply this regulation. And we recognize that there is additional guidance that is going to need to be made and hope that we see some of that over the coming years.

Liz Bowyer: Thanks Evan.

Evan Tylenda: Thanks Liz.