EU’s Sustainable Finance Disclosure Regulation linked to lower emissions, despite flaws

Though costly, Europe’s SFDR may cut greenhouse gas emissions by around 10% and encourage sustainable investment.



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Two years after the EU Sustainable Finance Disclosure Regulation (SFDR) took effect, the European Commission held an online session to collect feedback on the requirements, kicking

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off with an informal poll asking participants to complete the phrase “SFDR disclosures have…”

The clear winner — with 66% of the 630 respondents’ votes — was “created more confusion than clarity, raising the risk of greenwashing.” In a distant last place, with only 14% of votes, was “helped to change the behavior of investee companies.”

But that negative perception may not be an entirely accurate picture, according to research by IESE professors Gaizka Ormazabal, Fernando Penalva and Robert Raney, along with Jiyuan Dai of the University of Cyprus. On the contrary, the SFDR, while in need of finetuning, may produce a drop in carbon emissions in the portfolios of investment funds covered by the disclosure regulations.

Published in the Journal of Accounting and Economics, the research found that carbon emissions — including Scope 1, 2 and 3 — declined around 10% more in holdings of SFDR-bound funds than in comparable funds outside the European regulations. The decarbonization was the result of funds shifting investments to greener companies as well as firms in the funds’ portfolios cutting emissions, possibly in response to pressure from investors, the study found.

As the European Union conducts a review of the SFDR framework, and the U.S. and U.K. consider related legislation, the findings make an important contribution to how mandatory disclosure requirements on financial services may have real material impact on the environment.

Focus on light green and dark green investment funds

The SFDR requires investment funds to classify themselves under Article 6, 8 or 9 of the regulation, each entailing distinct disclosure obligations.

- Funds regulated under Article 6 do not claim to invest based on sustainability criteria and are exempt from the detailed sustainability disclosure requirements.
- Article 8 funds — dubbed “light green” by the market — promote sustainability and must disclose sustainability performance details for the fund.
- “Dark green” Article 9 funds invest in companies contributing to specific environmental or social objectives, such as carbon emissions reduction or gender diversity, and must present a detailed sustainability policy and report on the achievement of the objectives (including disclosing sustainability performance of the

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fund).

The study focused on the impact of SFDR on carbon emissions, rather than on other sustainability metrics, and examined a diverse sample of Article 8 and 9 investment funds. The changes in carbon emissions in the portfolios of these SFDR funds were compared with several different control groups of funds not subject to SFDR rules, including: funds that make a voluntary commitment to sustainability in their investment underwriting; Article 6 funds; and funds designated as sustainable funds by an independent rating agency.

Greenhouse gas (GHG) emissions by companies held in the portfolios of Article 8/9 funds were around 10% lower after the introduction of SFDR compared with those of the primary control group of funds. The reduction was greatest in direct GHG emissions (Scope 1) — down by 15.4% — although reductions were also observed in operational GHG emissions (Scope 1 and 2, down 13.3%) and total GHG emissions (Scope 1, 2 and 3, down 9.0%). Prior to SFDR, both the treatment and control groups of funds had broadly similar emissions patterns.

The declines were the result of funds, in the wake of SFDR, making proactive adjustments through divestment from firms with higher emissions and investment in lower emissions firms. There was also a discernable impact on corporate behavior itself, with companies owned by SFDR funds reducing their emissions more than companies owned by the control group of funds. One possible explanation for this is because these companies faced direct or indirect pressure from the SFDR funds.

The decarbonization was found to be more pronounced in funds whose investments showed higher emissions levels prior to implementation of the regulation, suggesting SFDR may have been particularly effective in the biggest polluters.

Social context played a role as well: there were larger reductions in funds domiciled in more sustainability-minded countries. For funds already exposed to some sort of mandatory environmental disclosures prior to SFDR, such as those in France, the impact was less.

Learning by doing: EU conducts SFDR review

The findings are unique in that much previous research focused on the outcomes of obligatory disclosure requirements on non-financial firms — which seem to encourage decarbonization — or on voluntary sustainability disclosures by financial firms — which find little evidence of decarbonization.

Despite the positive initial outcomes shown in this study, there is wide agreement that the

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SFDR is in need of the review currently underway. Financial services companies have criticized the regulations for being overly complex and imposing unreasonable compliance costs. Asset managers complain SFDR effectively punishes sustainable funds since they are bound by stricter disclosure requirements than funds without any regard for the environment. SFDR lacks clear definitions and criteria for the different types of funds, critics say.

Noting that the EU is breaking new ground in sustainability disclosures, Commissioner Mairead McGuinness said in the online feedback session that the review and adjustment are part of the expected process. “We’re learning by doing,” she said.



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