ESG

LUXEMBOURG

ESG: Significance and challenges in Luxembourg's investment funds industry

Marcus Peter and Marie-Thérèse Wich of GSK Stockmann explain the increasing importance of sustainable finance in Luxembourg's fund industry and consider the challenges to overcome

Luxembourg continues to be the leading hub for the establishment of investment funds in Europe. Despite the pandemic and the current situation in Europe (war in Ukraine, energy issues, inflation), the amount of assets under management (AUM) in Luxembourg remains stable, set to climb above €5 trillion at the end of December 2022.

Sustainable finance is an essential trend that has been increasingly driving growth and development in the fund industry during recent years. More initiatives have taken place, both at the EU and national levels, with the aim to reorient capital flows towards sustainable activities with a more ESG focus.

In the context of a global shift towards sustainable finance, driven by an ambitious regulatory agenda in the EU, international pressure from lawmakers and scientists, as well as the demand of investors, Luxembourg continues to advance quickly on this topic. It is recognised that the reshaping of finance and redirection of institutional and private capital towards greener and more sustainable environmental objectives and investments is accelerating.

For market participants, the main drivers towards ESG liquidity redirection are:

- Investor demand, based on a changing mindset towards sustainability and ESG risk management demands;
- Political and regulatory pressure; and
- Reputational considerations.

In the transition to sustainable development, Luxembourg continues to enhance the quality and quantity of sustainable finance products and services. In 2021, Luxembourg alone attracted 43% of the total net flows into European funds with 38% of those flows specifically directed towards sustainable funds, with a third of the assets managed by sustainable funds in Europe being domiciled in Luxembourg.

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Moreover, in December 2022, the credit rating agency Moody's confirmed Luxembourg's good ESG performance with a triple-A rating for sustainability for the second year in a row. The positive ESG credit impact score reflects Luxembourg's lower direct exposure to environmental and social risks and high capacity to respond to market disruptions, together with continued efforts in this area by the Luxembourgish government and financial market.

Regulatory framework

One of the main ESG regulatory advancements at EU level was represented by disclosure requirements at level 1 (Taxonomy Regulation and SFDR) and at level 2 (Regulatory Technical Standards (RTS)).

SFDR Level 1 implementation

The EU Sustainable Finance Disclosure Regulation 2019/2088 (SFDR), applicable since 10 March 2021, was the initial implementation of ESG provisions regarding sustainable finance. The SFDR requests financial advisors and financial market participants such as AIFMs, UCITS management companies and investment firms to comply with harmonised disclosure rules, mostly regarding sustainability risks and sustainability-related information. Since 30 December 2022, the consideration or non-consideration of principal adverse impacts on sustainability factors must also be reflected in the pre-contractual documents, in the annual report of a fund and on the website of the AIFM.

The set of disclosure requirements introduced by the SFDR concern two different levels: entity level (applicable at the level of the managers such as AIFMs), and product level (applicable at the level of AIFs, UCITS, separate accounts).

The SFDR provides for three different kinds of disclosure:

- Pre-contractual disclosure (to investors);
- Website disclosure; and
- Periodic disclosure (annual reports).

In particular, financial market participants need to publish the following information on their websites:

- How they integrate sustainability risks into investment decision-making processes;
- Whether they consider the principal adverse impacts that their investment decisions may have on sustainability factors;
- How remuneration policies take sustainability risks into account; and
- ESG information about the investment funds themselves, such as disclosures in offering documents and prospectuses.

Moreover, the SFDR provides for three different categories of financial products, each having specific disclosure requirements, such as:

- 'Light Green Products' or 'Article 8 Products' in accordance with article 8 of the SFDR: funds which promote, among others, environmental or social characteristics (or a combination of those characteristics). Besides the promotion of such environmental and/or social characteristics, such products can also carry out other non-ESG related investments;
- 'Dark Green Products' or 'Article 9 Products' in accordance with article 9 of the SFDR, which have sustainable investment as their principal objective. These types of products must comply with additional product level disclosures and have to describe their 'sustainability' in detail; and
- 'Neutral Products' or 'Article 6 Products' in accordance with article 6 of the SFDR and which do not take any ESG aspects into account.

Level 2 SFDR

The ESG disclosure requirements have remained only partially in force for a long time due to the absence of finalised RTS – the so-called Level 2. Until 1 January 2023, no specific guidelines applied to the Article 8 and Article 9 products. Consequently, financial market participants were flexible in the structuring of ESG Products.

Technical and formal guidelines as part of Level 2 were expected to apply as of 1 January 2022. However, the EU Commission, in its letter of 25 November 2021, informed the EU Parliament and the Council that it would not be able to adopt the relevant RTS and therefore postponed its application until 1 January 2023.

At last, on 6 April 2022, the EU Commission adopted a delegated regulation with the final set of RTS. This included both SFDR RTS, with prescribed-form reporting templates for Article 8 and 9 SFDR funds, and the Taxonomy Regulation-related RTS concerning all six environmental objectives.

The finalised RTS, formally approved in July 2022 by the EU Parliament and the Council, are finally applicable as from 1 January 2023. They expand and specify the contents and level of information both at product and entity level to be provided in relation to:

- The assessment of the principle of 'do no significant harm';
- Sustainability indicators and adverse sustainability impacts; and
- The proportion of environmental social characteristics (Article 8 products) and sustainable investment objectives (Article 9 products) in pre-contractual documents, websites and periodic reports.

If, therefore, during 2022 mandatory transparency disclosures had to be compiled on a mere best effort basis, financial market participants are legally required to comply with more stringent disclosure requirements. Especially regarding Article 8 and Article 9 products, the pre-contractual documentation of investment funds had to be updated until 1 January 2023. For regulated investment funds, the Luxembourg financial supervisory authority *Commission de Surveillance du Secteur Financier* (CSSF) introduced a 'priority procedure' to enable such ESG funds to implement the necessary amendments until 1 January 2023.

For financial market participants it could be challenging to prepare such level 2 amendments, especially regarding the pre-contractual disclosure templates (RTS annexes) due to missing market practice for the completion of those templates. For this reason, the CSSF published an FAQ about the SFDR on 2 December 2022 explaining to market participants some relevant points regarding the RTS and its implementation. Certain guidelines were also provided by the European Supervisory Authorities (ESAs) via a statement clarifying the draft RTS in June 2022.

However, the implementation process to ensure transparency and reporting in the ESG field is still under development. Indeed, just after adopting the final RTS, the EU Commission asked the ESAs to propose amendments to those RTS to:

- Broaden the disclosure framework with a view of extending the lists of universal indicators for principal adverse impacts, as well as other indicators; and
- Include the information that should be provided about the exposure of financial products to investments in gas and nuclear activities.

Subsequent changes to the current RTS regime – and therefore to the reporting obligations of financial companies - need to be implemented.

Taxonomy Regulation

Another impact on the SFDR is linked to additional sustainability-related disclosures introduced by the Taxonomy Regulation 2020/852. The Taxonomy Regulation is, in principle, a set of rules that is independent from the SFDR. However, for the definition of the environmental aspect (the 'E' of 'ESG' in this context), the SFDR refers to the Taxonomy Regulation.

In addition, the Taxonomy Regulation provides for disclosure obligations in relation to ecological aspects of the two new ESG fund categories. By way of example, it defines for Article 9 products what could be considered as an environmental objective that such a product could contribute to. Regarding Article 8 products, the Taxonomy Regulation obliges them to publish a disclaimer that the 'do not significantly harm' principle applies only to investments that comply with EU criteria for environmentally sustainable economic activities.

These disclosure requirements have been applicable as of 1 January 2022 in relation to the first two environmental objectives (climate change mitigation and adaptation), and as of 1 January 2023 for the other environmental objectives.

On 9 March 2022, the EU Commission adopted the Complementary Climate Delegated Act which included, under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the EU taxonomy. It was published in the Official Journal on 15 July 2022 and applied as of January 2023.

The Taxonomy Regulation covers only environmentally sustainable activities. However, the EU is currently working on a social taxonomy regulation, including a set of social objectives and a requirement for the activity to make a substantial contribution to the objective. In this regard, the EU's Platform on Sustainable Finance published its Final Report on Social Taxonomy in February 2022.

What is next?

With the introduction of the Level 2 RTS on 1 January 2023, a necessary step towards clarification and a uniform presentation of sustainable products and sustainability-related disclosure has been taken. This will provide investors with a more precise insight into financial products and shall help avoid 'greenwashing'.

In addition, on 17 February 2023, the Commission Delegated Regulation (EU) 2023/ 363 of 31 October 2022 amending and correcting the SFDR RTS was published. The regulation concerned disclosures about the exposure of financial products to investments in fossil gas and nuclear energy activities. It is applicable as of 20 February 2023. These amendments require financial market participants to update the RTS disclosure information in the pre--contractual fund documentation, especially regarding the so-called RTS annexes, shortly after the implementation of the initial RTS disclosures.

The year 2023 will require businesses to consider social and environmental issues, contemplate the impacts of their operations and make efforts to minimise negative effects. The EU's initiatives to enhance ESG disclosure and reporting will expand the requirements of previous initiatives and bring considerably more companies within its scope.

In addition to ESG disclosure, other legislative proposals and consultations launched by supervisory authorities are rapidly taking place, and these will provide more ESG and reporting obligations for market participants.

"Tendency shows that bigger fund managers are better prepared for the upcoming regulatory challenges"

Among others, on 18 November 2022, the European Securities and Markets Authority (ESMA) published a consultation paper on guidelines on funds' names using ESG or sustainability-related terms. To prevent potential greenwashing risks, ESMA is proposing to allow the use of ESG and sustainability-related labels in funds' names upon stringent conditions. The publication was followed by an open hearing and consultations shall end in February 2023, which will allow ESMA to finalise its guidance within the next few months.

Outlook

Multiple challenges for investment funds, managers and initiators linked to compliance with ESG-related rules are looming on the horizon. Uncertainty of interpretation, continuous changes in guidelines, mandatory deadlines and the lack of available ESG data for disclosure requirements are among these.

The expanding demand from the market for more ESG-compliant financial products came with tighter sustainability regulations as well as with increasingly detailed reporting obligations. It is therefore now critical for financial market participants to build specific expertise in ESG topics. The changing environment of ESG provisions and publications needs a certain supervision and follow-up to not miss any relevant changes. This may involve equipping the management body with specific ESG competences, providing for dedicated ESG internal committees, as well as designing dedicated training processes and hiring ESG experts.

Moreover, there will hardly be a considerable amount of ESG data available in the short-term. For big parts of entire asset classes this data simply does not exist, and for others, can be difficult to obtain when the investment targets are not located in the EU. To address funds classifications and comply with the related disclosure requirements, companies require better data from third-party data providers to assess which sustainability risks they are exposed to and the impact of their investments on people and the environment.

On the other hand, it is clear now that compliance with those reporting and disclosure requirements will be a hurdle for the industry. Mitigating the above challenges should therefore be the strategy, by getting more familiar with the new rules and taking steps to implement them as far as possible. Those that can do so in a cost-efficient manner might benefit in terms of performance, growth of AUM and market reputation.

Tendency shows that bigger fund managers are better prepared for the upcoming regulatory challenges and are ready to implement these regulatory provisions in their internal processes and procedures.

ESG funds (Article 8 and 9 products) have grown rapidly over recent years and the trend will continue in the years to come, mainly due to investor and market demands. Many fund managers and fund initiators either start to re-classify their non-green funds into an ESG product or increasingly set-up products which qualify as ESG funds. ESG is a common topic at any investment fund conference, which reflects its growing importance. Although ESG fund performance may continue to be challenged by the macro-environment and the current energy crisis, investors should be constantly reminded that all investments, including ESG and sustainable strategies, can go through periods of underperformance. Nevertheless, sustainable finance presents significant opportunities for the fund industry from a long-term perspective.

Marcus Peter
Partner
GSK Stockmann

Marie-Thérèse Wich
Senior associate
GSK Stockmann