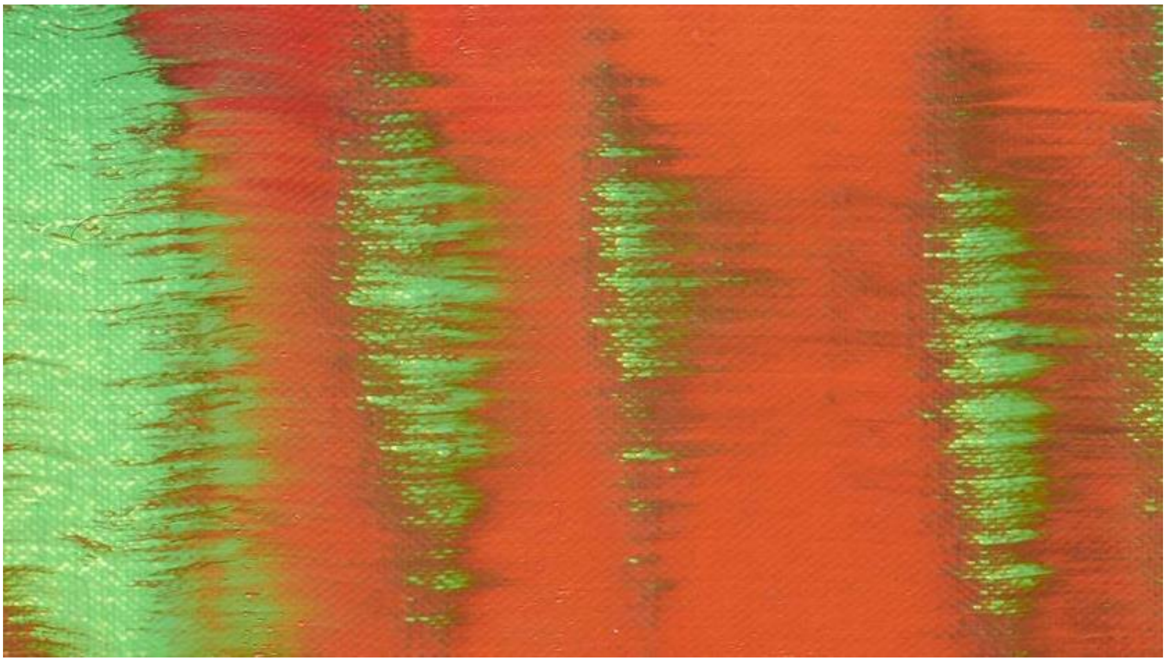
Europe's fund managers get a green makeover

Much like SEBIs Categorization and Rationalization of Mutual Fund Schemes changed the landscape for mutual funds in India, EU's Sustainable Finance and Disclosure Regulations is set to change the funds management industry in Europe.



Securities and Exchange Board of India's circular of 6 October 2017 upended the Indian mutual fund industry. This circular, on the 'Categorization and Rationalization of Mutual Fund Schemes' was aimed at bringing in uniformity in the labelling of various schemes. Since these guidelines have taken effect, investing in large cap scheme means putting money in a fund that has over 80% invested in the equity of the 100 largest companies by market capitalization. Equivalent definitions extend across all categories.

An end to greenwashing

Much like SEBIs rules altered the Indian mutual fund industry, European funds are getting a makeover as the European Union (EUs) Sustainable Finance and Disclosure Regulations (SFDR) and the accompanying regulations, that have taken effect from 10 March 2021.

ESG or sustainable investment has grown exponentially in recent times. Depending on the data source you turn to, between US$ 30-50 trillion is now invested in ESG labelled funds, with Europe accounting for the largest share. As disproportionately more money is flowing to such funds, many have misleadingly labelling themselves as green to attract more investors.

In a manner analogous to SEBIs rules above, EU has rolled out regulations aimed at disciplining this end of the market - or to use the industries jargon on it, prevent greenwashing.

SFDR in conjunction with its ‘Regulation on climate benchmarks and sustainability-related disclosures for benchmarks’, and the ‘EU Taxonomy Regulation’, emphasize Europe’s commitment to more sustainable business. This explains why these rules are not just limited to those funds that call themselves green but extend across all funds. Each asset and portfolio manager, pension fund, bank, and insurance company will now need to look beyond financial numbers and integrate ESG (environment, social and governance) parameters into their investment decisions.

Do no evil disclosures

The EU regulations now outline disclosure requirements across three levels. First, funds are expected to provide information about the ESG risks in their portfolios. Second, make disclosures regarding the adverse’ impact of their investment decisions on sustainability factors and their policies on how they measure and track this impact. And if they do not to factor the adverse effects of their investment decisions, they must disclose clear reasons for not doing so, including, where relevant, information on whether and when they intend to do so. And three is the publication of sustainability-related information - where a sustainability objective is targeted.

And while these are ‘comply or explain’, the way these rules are written means that it will be hard to get distributors to sell your product or for advisors to recommend a fund if it does not comply. And while funds have raised red flags regarding data integrity and the appropriateness of the 18 parameters that they need to disclose regarding their investee companies, there is no getting away.

There is much more to these rules than what I has been described above, including those relating to its taxonomy – which deserves its own blog.

Meanwhile, across the Atlantic

As EU has taken a giant leap in this direction, attention has now shifted to America and the Securities and Exchange Commission (SEC). American funds selling in Europe are now expected to comply, so such regulations will not be something new for the larger and more global US funds. In addition, there are two other pointers. First the Biden administration’s commitment to climate issues and the Paris accord. His government is trying to make up for lost time under the previous regime. Second, the SEC for the first time has a senior policy advisor for climate and ESG. Acting SEC Chair Allison Herren Lee (- a Donald Trump appointee) had created the position earlier this year and this appointment is a clear signal of the primacy of ESG issues in capital markets. And as Gary Gensler (- a Biden appointee), has taken over the reins, this focus will continue. It is worth mentioning that the SEC issued a Risk Alert memo, “Reviewing ESG Investing”, listing the gaps and best practices that have been observed. Many see this as a preparatory work for what could ultimately be the American equivalent to the EUs SFDR.

At home

The Indian market is slowly putting the various building blocks in place. For one the government is committed to meeting its targets under the Paris agreement. After nearly a decade, how companies will report of ESG has been given a refresh – with the Business Responsibility Reports (BRR) making way for Business Responsibility and Sustainability Reporting (BRSR). The Indian Institute of Corporate Affairs in a 2019 study had reviewed disclosures of 490 companies and concluded that while the reports are complete, they were found wanting in both accuracy and clarity of the responses. The new BRSR might address some of these issues, but the focus needs to be on greater standardization for data to be more meaningful.

At last count there are 11 domestic 'ESG' funds with an AUM of US$1.6 billion. My sense is that even as more funds are being launched, the industry's move towards ESG integration is gathering steam. In this context is appropriate that Indian regulators examine the applicability of the European regulations today, rather than scramble to catch up once the edifice has been built.

The global rollout of Climate Related Financial Disclosures, and other related developments will no doubt all be important milestone. But the next big change in our asset management industry will happen when SEBI rolls out its equivalent of the SFDR regulations.

A modified version of this blog appeared in Business Standard on 16 June 2021. You can access it by clicking this link: https://www.business-standard.com/article/opinion/europe-s-fund-managers-get-a-green-makeover-121061501577_1.html

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