

European Traditional Investment Managers Increase Focus on ESG

Importance of Sustainability Transparency to Grow for Managers

Key Points:

- European traditional IMs' focus on sustainability has accelerated, helped by the EU's Sustainable Finance Disclosure Regulation.
- A significant proportion of funds are classified as Article 6 (non-sustainable, do not integrate any kind of sustainability into the investment process).
- Article 8 (promoting environmental or social characteristics) and Article 9 (having sustainable investment objectives) classifications are gaining ground.

Related Research

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[Fitch Ratings 2021 Outlook: Global Investment Managers \(November 2020\)](#)

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ESG Adoption Gains Momentum

European traditional investment managers (IMs) are increasingly focusing their fund offerings on ESG (environmental, social and governance) factors, particularly environmental sustainability.

The process has accelerated, helped by the EU's Sustainable Finance Disclosure Regulation (SFDR), which aims to make funds more transparent and easier to differentiate with respect to sustainability. Sustainable fund assets under management (AUM) were 11% of European AUM at end-2020.

Net inflows for sustainable funds were a record EUR233 billion in 2020 according to Morningstar, more than twice the amount for 2019, with 505 sustainable funds entering the market. Most demand for sustainable products in recent years has been from institutional investors, but there are signs that ESG momentum is gaining traction with retail investors.

Fitch Ratings surveyed rated traditional European IMs after the phase one implementation of SFDR on 10 March 2021. We found that rated IMs classify a significant proportion of their funds as Article 6 (non-sustainable, do not integrate any kind of sustainability into the investment process).

However, there is momentum towards Article 8 (promoting environmental or social characteristics) and Article 9 classifications (having sustainable investment objectives).

Sustainability has become a differentiating factor for investors, leading to increasing pressure on European traditional IMs to meet the stricter ESG criteria for Article 8 and Article 9 classification. IMs that lag could lose market share and AUM unless they can differentiate themselves in other ways, for example, by superior performance net of fees.

EU Regulation Drives ESG Transparency

SFDR aims to further the EU's sustainability and climate change goals through disclosure requirements. It compels financial market participants to make sustainability disclosures in a more standardised way, better informing retail and institutional investors of the sustainability risks of their investment decisions.

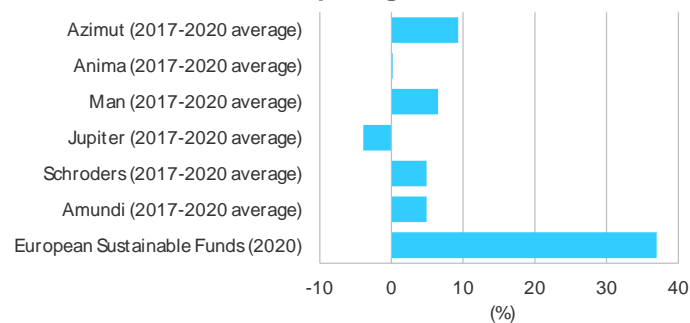
SFDR requires disclosures at both entity and product level. These include how IMs factor sustainability into investment decisions, how they align remuneration accordingly and how sustainability affects investment returns.

Disclosures must be made in pre-contractual product documentation, periodic documentation and on IMs' websites. The EU's Taxonomy Regulation, which was implemented in 2020, feeds into SFDR as it aims to address the issue of "greenwashing" (labelling that exaggerates products' sustainability) by introducing a common set of standards for sustainability classification.

ESG Fund Growth Outpacing the Market

Data from Morningstar and company filings highlight the extent to which ESG funds are growing faster than the overall European market. Net flows into European ESG-focused funds in 2020 were 37% of end-2019 AUM. This compares with average annual net flow rates over 2017-2020 of less than 10% for the overall funds managed by each of the European traditional IMs publicly rated by Fitch.

Annual Net Fund Flows/Opening AUM



Source: Fitch Ratings, Morningstar, company filings

Sustainable funds' AUM were EUR1,101 billion at end-2020 (still only 11% of total European AUM), but they accounted for 45% of total European net flows in 4Q20, according to Morningstar.

MiFID Shift May Increase ESG Funds Flows

The European Commission recently published its final amendments to the Markets in Financial Instruments Directive (MiFID) suitability rules. The amendments cover how firms should take account of investors' 'sustainability preferences'; the rules are due to come into force in late 2022 provided there are no objections from the European Parliament or Council.

In combination with the SFDR, the MiFID amendments could soon prevent IMs from marketing non-sustainable (ie Article 6) products to retail clients who indicate a sustainability preference. Providers of financial advice will also be prohibited from marketing financial instruments that do not meet clients' sustainability preferences.

Consequently, we expect the MiFID amendments to support increased flows into ESG-oriented funds (Article 8 and Article 9). However, the effect is likely to be gradual, depending on retail investors' ESG momentum.

The new rules may have a greater impact on IMs that rely on third-party distribution networks as preferential distribution agreements could be superseded by SFDR-compliant marketing restrictions, reducing net flows. In contrast, IMs with their own distribution capability may face fewer distribution and organisational challenges.

The rules will apply also for investment products offered by EU-based private banks (ie banks focused on wealth management for high-net-worth individuals). However, the impact should be limited as private banks typically use a range of external IMs for their investment offerings and should, therefore, be able to source Article 8 or Article 9 products in most cases.

Regulatory Differences with US May Narrow

In contrast to the EU, the US and the UK currently have a voluntary framework for ESG disclosure. However, we expect the US and the UK to adopt more prescriptive regulatory approaches in the coming years.

From a global perspective, the International Organization of Securities Commissions (IOSCO) aims to address the risks of divergent regulatory approaches. In June 2021, IOSCO published a consultative proposal for sustainability-related regulatory and supervisory expectations for asset management.

Recent initiatives by the US Securities and Exchange Commission (SEC), including an ongoing public consultation, show the growing importance of ESG disclosure for US regulators and investors. The ESG Subcommittee of the SEC's Asset Management Advisory Committee has said that ESG disclosures should aim to improve the transparency and verifiability of ESG strategies and practices.

The SEC is likely to give more detail on its approach in 2H21 after the conclusion of its recent public consultation. We expect investor demand will lead to an approach similar to the EU's SFDR, but some differences are likely to remain.

The UK has not adopted SFDR into law post-Brexit. However, the Financial Conduct Authority (FCA) is consulting on similar provisions based on the Financial Stability Board's 'Recommendations of the Task Force on Climate related Financial Disclosures' report, which was published in 2017.

UK IMs currently only need to comply with SFDR to the extent that they market their funds in the EU. However, we expect them to become subject to similar disclosure requirements for funds marketed in the UK. The FCA's consultation is due to be completed by September 2021.

Rated IMs Can Absorb Regulatory Costs

Fitch publicly rates six European traditional IMs: Amundi, Anima Holding S.p.A., Azimut Holding S.p.A., Jupiter Fund Management PLC, Man Group Plc and Schroders plc. We believe they are well-positioned for the regulatory changes ahead and we do not expect regulation to have a significant effect on their credit profiles in the next 12-18 months.

Fitch-Rated European Traditional IMs

IM	Country	Long-Term Issuer Default Rating
Amundi	France	A+/Stable
Schroders	UK	A+/Stable
Man Group	UK	BBB+/Stable
Jupiter Fund Management	UK	BBB/Stable
Azimut	Italy	BBB-/Stable
Anima	Italy	BBB-/Negative

Source: Fitch Ratings

Sector-wide margin pressures continue to weigh on IMs. However, we believe the six Fitch-rated IMs should have sufficient ratings headroom to absorb the significant cost of implementing SFDR, helped by their large operational scale and strong earnings. Their

EBITDA margins, net of performance fees, were mostly above 30% in 2020, providing a sizeable buffer to absorb extra costs in the short term.

The Fitch-rated IMs did not incur significant additional costs from implementing the first phase of SFDR. The main extra costs were for new dedicated ESG headcount and subscriptions for data from sustainability rating agencies.

We expect the total costs of SFDR compliance to be higher and largely fixed in nature, which could disproportionately affect smaller IMs. Firms may be able to recoup costs if flows (and, therefore, fees) increase, or by applying higher charges on Article 9 products. Investor demand could support growth in specialist impact investment funds with higher associated charges.

Among the most significant ESG disclosures for IMs are the proportions of AUM that they intend to classify as Article 8 and 9. All of the Fitch-rated IMs have added an ESG component to their products, mostly in the form of investment exclusion lists or by defining the ESG factors applied in the investment process. However, most of them have not yet met the tighter requirements for the majority of AUM to qualify for Article 8 or 9 classification.

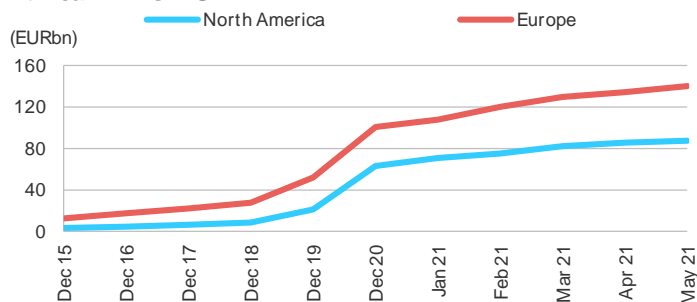
We believe IMs are taking a cautious approach to applying labels that imply higher ESG standards, due to their desire to avoid allegations of greenwashing, which could lead to reputational damage, regulatory fines and litigation. We also believe that most IMs are not yet seeking to compete on Article 8 or 9 classification, particularly for retail clients. Interest for ESG products among retail investors is still niche, although growing.

Some IMs with more developed ESG franchises are publishing sustainability metrics that are being used for benchmarking by other firms. Amundi, for example, disclosed in February 2021 that 60% of its overall European mutual funds' AUM were classified as Article 8 or 9.

ESG-Oriented ETFs Also Grow Fast

European ESG-orientated exchange-traded funds (ETFs) are also seeing rapid growth. Their AUM increased to EUR82.5 billion at end-2020 from EUR32.1 billion at end-2019, according to Morningstar data. Lipper data for 'ethical' ETFs, which are also ESG-focused, show similarly rapid AUM growth.

Ethical^a ETFs' AUM



^a ESG-focused
Source: Fitch Ratings, Lipper

Passive ETF products pose a competitive threat to actively managed funds, provided they can credibly and consistently deliver on their stated ESG and performance objectives. Some active IMs are likely to seek to differentiate themselves by focusing on more bespoke ESG products, including Article 9 funds with more clearly defined sustainability objectives.

More Transparency to Boost ESG Investing

There are still significant issues to resolve to support the growth of sustainable investing. Several recent studies have pointed to significant disparities between ESG ratings from different ESG rating providers. This highlights the lack of clear standard definitions of sustainability.

In January 2021, the European Securities and Markets Authority wrote to the European Commission calling for greater regulation of ESG ratings and assessment tools, including a common definition of ESG ratings.

More recently, in May 2021, members of the US Congress introduced two pieces of legislation that could increase sustainable investments. The Sustainable Investment Policies Act and the Retirees Sustainable Investment Opportunities Act together would require large US asset managers and retirement plan investors and fiduciaries to explain to beneficiaries how they consider ESG factors when making investment decisions.

We expect transparency on ESG to improve over time. This should fuel momentum for sustainable investments and create growing opportunities for IMs to expand their franchises.

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