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Executive Summary of the Thesis

A Framework to evaluate ESG disclosure under EU regulation in the Italian financial services sector

Laurea Magistrale in Management Engineering - Ingegneria Gestionale

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1. Introduction

Sustainable finance has been developing during the last years to support the many economic, environmental, and social challenges that are seriously undermining the sustainable development of the economy. Among these issues, commonly collected under the "ESG" label (Environmental, Social, and Governance), Matos (2020) highlights climate change, workforce health and safety, and the safeguard of Shareholders' rights. The main concern, indeed, is that they could potentially affect firms' value creation. Particularly significant, then, is climate change, as also witnessed by the many international initiatives aimed at tackling this delicate challenge. United Nations' SDGs and Paris Agreement are just some of the many possible examples, but they are considered relevant since they explicitly envisage finance as a tool to mobilize capital flows towards greener and more equitable businesses. ESG, therefore, has become a widespread driving force to investments and it can also be led by demand from investors who would like to see their wealth allocated in more sustainable ways. Furthermore, the European Union is playing a crucial role in the sustainable finance field since, in 2018, it finalized the "Action Plan on Financing Sustainable Growth", outlining a 10-steps strategy connecting finance with sustainability. One relevant point that has being raised by the project is the issue of ESG information disclosure, especially from actors in the financial services industry, and it has been specifically addressed by a set of rules and directives. Among these policies, the thesis focuses on the Sustainable Finance Disclosure Regulation (SFDR, Regulation EU 2088/2019), which establishes rules for financial market participants and financial advisers on transparency regarding sustainability risks integration in their processes. Moreover, one key aspect that the SFDR and all the other ESG disclosure policies aim at tackling is the so-called "Greenwashing", that is the use of deceptive strategies to promote a sustainability-oriented image (Migliorelli, 2021). One of the possible causes to this phenomenon could be given to the lack of consensus on the definition to sustainable finance.

2. Literature Review

The literature examined focused on the analysis of the different facets of sustainable finance, its evolution and the European regulatory environment that has being developing in the last

years around it. ESG investing, that is the consideration of Environmental, Social, and Governance factors during the evaluation of an investment, can be seen as the first materialization of sustainable finance within financial markets. Since 2019 the ESG investing industry has sharply grown, fostered by extreme events like COVID-19 which shifted investors' attention towards more sustainable businesses, since they already proved to face crisis events better than other sectors. This trend has been witnessed both in the EU and in the US, with the former assuming a much more relevant role than the latter in this field, as 50% of global sustainable markets are denominated in euro (Janse and Bradford, 2021).
However, this is not surprising if considering the great effort that the EU has spent into designing sustainable finance-oriented policies. Nevertheless, this process has come after the creation of several connections between sustainability and finance worlds like, for instance, Socially Responsible Investments (SRI). The popularity of this relatively new class of investments, which presents a framework for reflecting investors values (Napoletano and Curry, 2022), is indeed testified by the growing number of signatories of PRI, an international investors network which is regarded to be among the world's leading proponents of SRI.
Starting from the definition of six principles, indeed, PRI aims at offering investors with a menu of potential activities for integrating ESG issues into investment practices and making the financial system more sustainable. Furthermore, different approaches or criteria to consider ESG factors into investments decisions can be identified. Schoenmaker (2018), indeed, defines three levels or strategies to sustainable finance, differing from each other mainly for the counterparty whose value is maximized and the nature of the impact (Financial, Social or Environmental) which drives the financial activity. The three approaches to sustainable finance are:

- **Negative screening:** it entails the avoidance of financing "sinful" businesses.
- **ESG Integration:** it involves the methodical and deliberate consideration of ESG issues in the financial analysis process.
- **Positive screening:** it implies investing in sustainable initiatives and projects only.

The maximum expression of SRI is represented by the third level since it best embraces the blended value concept, defined as the expression of the commitment toward the generation of financial as well as social and environmental contributions, embracing a holistic approach to value creation (Emerson, 2003). In addition, there are other two strategies which are very relevant for sustainable finance: Shareholders' engagement and Impact Investing. The former refers to all those stockholders' initiatives and contributions like exercising the right to vote on shareholders' proposals during annual general meetings and discussions during informal meetings with management with the aim of improving the social and environmental impact of the investee (Kolbel et al., 2020). Moreover, literature has revealed evidence even for a financial return increase for those companies who are interested by such process (Dimson et al., 2015). Impact Investing, on the other hand, has been the object of many interpretations and definitions, but can be considered as the injection of capital into businesses, funds and non-profit organizations with the aim of producing social and environmental benefits, together with financial returns in an intentional and measurable way (Rockefeller Philanthropy Advisors, 2020). However, this label is occasionally applied in a deceptive way to those financial products which are not actually pursuant of an impact strategy, even if this is often the consequence of a misconception by asset managers of what this kind of investments actually imply.
Strictly connected with what has been discussed so far is the evolution process of sustainable finance since, as Ahlström and Monciardini (2022) argue, it historically followed the shifts in the relationships between the financial logic and sustainability goals which also led to the designation of ad-hoc policies. These legislative interventions, as already mentioned, mainly come from EU, which is playing, worldwide, a major role in this field. The designation of an ESG Framework by the EU started in 2010 but it received great momentum in 2015, after the set-up of global initiatives, such as UN's SDGs and Paris Agreement, which pledged to use finance

as a tool to mobilize capital to reach a more sustainable society and to assist the fight to climate change. Therefore, in 2016, the European Commission established a High-Level Expert Group on sustainable finance (HLEG) which helped in the development of the "Commission action plan on financing sustainable growth", adopted in March 2018. Among the measures that have been included in this project, particularly relevant is the Sustainable Finance Disclosure Regulation (SFDR) which lays down harmonized rules for Financial Market Participants and Financial Advisers in their communications regarding the financial products they are involved with and their process of sustainability risks' integration. This Regulation, besides requiring the publication of different sets of information on websites, pre-contractual disclosures, and periodic reports, introduces a classification based on the purpose of the different financial products. Articles 8 and 9 SFDR, indeed, outline disclosure obligations for financial products which, respectively, promote Environmental or social characteristics and have, as their objective, a sustainable investment. Moreover, the SFDR shed light on the relevance of ESG Disclosure which contributes to provide a full picture on the firm, thus reducing information asymmetries for investors. Therefore, policy interventions in this field have also been designed to address the standardization issue since, as already discussed, the notions of "green" and ESG are often prone to subjective interpretations. The SFDR, for instance, is one example of those measures thought for enhancing comparability between financial products. At this point the question is whether the EU sustainable finance framework can have an impact on a global scale or not. One possibility is represented by the Brussels Effect (source, Anu Bradford), which manifests when the EU issues a regulation in a sector, and it is followed by other regions in the world to be able to operate in the market (Redondo Alamillos and de Mariz, 2022).

3. Research Question

The literature reviewed covered many topics, exploring the different ways of conceiving sustainable finance and its evolution. Great emphasis has been given to SFDR and its role of promoting standardization and transparency for ESG disclosures in the financial services sector and, hence, this led to the formulation of the first research question: "What is the level of alignment, as of today, reached by Financial Market Participants and Financial Advisers towards Regulation 2019/2088 EU (SFDR)?" Secondly, the panoramic view on the different approaches to sustainable finance that have been discussed raised a second question: "Which are the most widespread approaches to ESG investing in the financial industry?"

4. Empirical Analysis

The research that has been carried out required the set-up of a Database collecting a large batch of standardized information of over 400 Financial Market Participants (FMPs) and Financial Advisers (FAs) websites. The scope of this process was to provide a picture on the ESG Italian Financial sector, taking as reference the SFDR. Eventually, the research perimeter has been identified and divided as reported in the exhibit below.

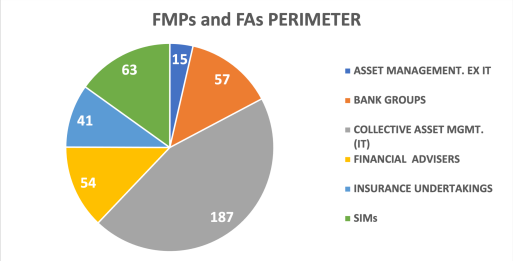

Figure 1: Research Perimeter

The perspective that has been adopted during the research was the one of a retail investor who is willing to make a sustainable investment or, alternatively, is looking for some information about the sustainability of different products, without necessarily being bounded to invest sustainably. Therefore, the analysis that has been carried out on the subjects included in the sample aimed at checking the presence of two sets of information on their websites' disclosures: one regarding the content of the SFDR and one relative to the approaches and practices to sustainable finance. Accordingly, two groups of pre-defined measures have been identified, referring to specific statements, descriptions, explanations of different nature found within FMPs and FAs sustainable finance disclosures on their

websites.

SFDR - Based Measures	Best Practices
Website's section about policies on the integration of sustainability risks (3)	Shareholders' Engagement
Description of actions and engagement policies about PAIs (4)	Definition of mitigation actions to address PAI
Remuneration and incentive policies that take into account sustainability risks (5)	ESG Consideration
Disclosures about the integration of sustainability risks into investment decisions and investment advice (6)	ESG Rating
Disclosures for products promoting environmental or social characteristics (8)	Integration of greenhouse emission measurement
Disclosures for products with sustainable investment objective (9)	ESG Monitoring
Reference to adherence to responsible business conduct codes, standards for due diligence (4)	ESG Governance
Products must indicate whether there is a designated benchmark and whether that benchmark is coherent with E,S characteristics (8-9)	Negative Screening
Inclusion of the objective of low carbon emission exposure in view of achieving objectives of the Paris Agreement (9)	Positive Screening
Description of E,S or Sustainable Investment on the website (10)	Thematic ESG Investing
	Impact Investing

Table 1: Average SFDR Entity-level articles' measures adoption

Hence, for each FMP and FA, the Database keeps track of the measures they adopt, and at the end it reveals a complete picture on the level of integration of SFDR dispositions and rate of adoption of the best practices.

5. Results

5.1. Outcomes

The outcomes of the research are expressed along three dimensions: (1) the alignment towards the SFDR articles' measures, (2) the rate of adoption of best practices and (3) the alignment towards SFDR entity-level articles only.
First, the whole list of measures has been divided according to the three rationales expressed above (1), (2), (3). Second, three ratios have been defined computing, for each subject in the sample, the fraction of the measures adopted over the total number of measures in the respective category. Hence:

SFDR Alignment Ratio:

$$R1 = \frac{\text{Number of verified SFDR based measures}}{\text{Total number of SFDR based measures}}$$

Best Practices Ratio:

$$R2 = \frac{\text{Number of verified best practices measures}}{\text{Total number of best practices meaures}}$$

Entity-level SFDR Alignment Ratio:

$$R3 = \frac{\text{Number of verified SFDR entity-level articles' measures}}{\text{Total number of SFDR entity-level articles' measures}}$$

The average results on the whole sample reveal that R3 has the highest value, 58.75% while the other two ratios, have much lower numbers, 35.08% for R1 and 29.31% for R2. This result is not surprising if considering that entity-level articles, namely art. 3, 4 and 5 SFDR are mandatory and need to be published on a clear and visible website area. To furtherly detail the analysis, then, the three ratios have been broken-down into their constitutive measures to reveal the respective rate of adoption for each of them. Below, the insight on R3 is reported:

R_3 Measures	NO	YES	TOTAL	%
Website's section about policies on the integration of sustainability risks (Art. 3)	111	306	417	**73,38%**
Description of actions and engagement policies about PAIs (Art. 4)	120	297	417	**71,22%**
Remuneration and incentive policies that take into account sustainability risks (5)	285	132	417	**31,65%**

Table 2: Average SFDR Entity-level articles' measures adoption

Another insightful result regarding the frequency of investment approaches that FMPs and FAs claim to adopt in their activities emerges when analysing the measures that make up R2. The outcome is reported in the table below:

Investment Approaches	NO	YES	TOTAL	%
Negative Screening	220	197	417	47,24%
Positive Screening	343	74	417	17,75%
Thematic Investing	388	29	417	6,95%
Impact Investing	357	60	417	14,39%

Table 3: Perimeter observations on disclosure of approaches to ESG investments

5.2. Discussion

The series of data that have been gathered during the investigation of FMPs and FAs websites' sustainability disclosures can provide interesting insights when dividing the research sample into different categories. This is what has been done in the "cluster analysis", in which several criteria have been selected to regroup each element of the perimeter like, for instance, the main business activity they carry out (Asset Management,

Insurance, Brokerage, etc. . .). The ratios identified in the previous section, therefore, can be observed following this rationale, as shown in the table below.

Subject Type	R1: Average of SFDR Compliance Ratio	R2: Average of Best Practices Ratio	R3: Average of Mandatory Measures
ASSET MANAGEMENT. EX IT	48,67%	54,55%	75,56%
BANK GROUPS	38,25%	33,17%	64,33%
COLLECTIVE ASSET MGMT. (IT)	37,75%	36,66%	64,17%
FINANCIAL ADVISERS	31,11%	4,32%	35,80%
INSURANCE UNDERTAKINGS	46,10%	42,35%	78,05%
SIMs	17,30%	10,97%	40,74%
Total	**35,08%**	**29,31%**	**58,75%**

Table 4: R1, R2, R3 average values vs Subject Type

From these results it is possible to notice some variability among the different types of FMPs and FAs with SIMs and Financial Advisers exhibiting the lowest level of alignment in the three ratios. Another break-down of the three ratios can be revealed when dividing the perimeter according to the consolidated assets amount on Balance Sheet (2020) reported by FMPs and FAs:

Asset Size	Average of SFDR Compliance Ratio	Average of Best Practices Ratio	Average of Mandatory
below 1 mEUR	28,41%	10,09%	40,58%
from 1 mEUR to 10 m EUR	27,10%	22,56%	52,02%
from 10 mEUR to 100 m EUR	46,09%	44,55%	78,26%
from 100 mEUR to 1000 m EUR	41,61%	42,82%	60,22%
over 1000 m EUR	44,05%	40,48%	72,62%
n.a.	28,07%	23,04%	48,54%
Total	**35,08%**	**29,31%**	**58,75%**

Table 5: R1, R2, R3 average values vs consolidated assets (2020)

As can be noticed, no clear pattern and correlation between asset size and disclosure (measured through the three ratios) can be recognized, even though actors in the lowest two tranches exhibit the lowest values. However, for what concerns R1 and, hence, the disclosure of SFDR articles found on websites, financial players with more than 10m € in consolidated assets are more prone in complying with the regulation. The same holds for the other two metrics. Table below, then, reports the frequency of the disclosure of the SFDR product-level articles observed for the subjects in the sample, divided by their main business:

Subject type	% Art. 6	% Art. 8	% Art. 9	% Art. 10
ASSET MANAGEMENT. EX IT	80,00%	60,00%	60,00%	53,33%
BANK GROUPS	52,63%	38,60%	15,79%	26,32%
COLLECTIVE ASSET MGMT. (IT)	51,34%	26,20%	12,83%	26,74%
FINANCIAL ADVISERS	46,30%	-	-	-
INSURANCE UNDERTAKINGS	56,10%	29,27%	12,20%	26,83%
SIMs	11,11%	7,94%	6,35%	7,94%
Total	**46,28%**	**26,72%**	**14,05%**	**24,52%**

Table 6: Frequency of SFDR product-level article disclosures vs subject type

As can be noticed, it is more frequent to find art. 8 product disclosures than art. 9 for each category of FMPs and, proportionally, the offer of those products is more frequent by Foreign Asset Managers and Bank Groups. Looking at this result, but dividing the sample by consolidated assets size, it is not possible to conclude that investments classified under art. 8 and art. 9 are more often supplied by bigger financial players since disclosures for those products have been witnessed proportionally more often from FMP included in the two tranches of asset size going from € 10 millions to € 1 billion. Although art. 6 SFDR is mandatory, in the sense that even those FMPs and FAs not supplying sustainable products must disclose their sustainability risk integration process, it can be noticed how not all the elements in the perimeter provide such disclosure on their websites, with SIMs lagging well behind with respect to peers. Another interesting evidence, then, is found when putting into relation the type of product supplied by FMPs and the investment strategy they claim to follow. Table below reports how many FMPs disclose their offer of art. 9 products while claiming to pursue an impact investing strategy:

IMPACT INVESTING	Disclosures for products with sustainable investment objective (9)			
	no	yes	Total	%
no	290	14	304	4,61%
yes	22	37	59	62,71%
Total	**275**	**51**	**326**	**15,64%**

Table 7: Impact Investing vs Art. 9 products disclosures

This relationship has been highlighted as many industry professionals refer to products related to Article 9 as impact investments (Krombholz et al., 2022), even though the SFDR definition does not support this conclusion. Of course, this is strictly related to the "impact washing" concern. However, the table shows that most of FMPs offering art. 9 products (37 out of 51) also declare to follow an impact investing approach. The same analysis has been repli-

cated on art. 8 products and positive screening, seen as a coherent strategy with this category of investments, but what has emerged is that 56 out of 97 FMPs offering those investments did not claim to select possible investees following a "best-in class" approach. Coming to the best practices, hence measures relative to R2, it has been observed how statements on "ESG Consideration", namely the inclusion of a methodical and deliberate review of ESG issues during the general administration of investment/ advisory activities, have been the most frequently found within financial actors' disclosures (52.76%). On the other hand, the definition of mitigation actions for Principal Adverse Impacts (PAIs) of investment decisions (art. 4 SFDR), have been rarer to observe. Although great variability can be noticed among financial actors of different types, Financial Advisers and SIMs are, again, the ones which adopt best practices at a much lower frequency than the other categories. Article 4 SFDR, then, requires FMPs and FAs to provide a reference to adherence to responsible business conduct codes and standards for due diligence. Therefore, graph below reports how many actors in the perimeter adhere to those principles since, at least, they could help a hypothetical investor to understand whether a financial organization is referring to some internationally accepted guidelines when laying down its sustainable finance policies or not

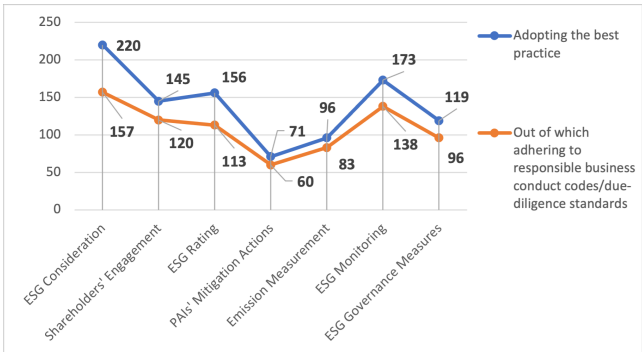

Figure 2: FMPs and FAs adopting each of the defined investment practices who also adhere to responsible business conduct codes and due diligence standards

Although it can be observed an overall good level of participation and adoption of responsible investment principles, some subjects do not (explicitly) rely on them when claiming to integrate the market practices under analysis. Ultimately, the two dimensions of the research have met when linking the investment principles expressed by the set of measures "best practices" with the type of financial product offered by FMPs, adopting SFDR classification (art. 8 vs art. 9). The outcome is that FMPs who do not offer art. 8 nor art. 9 products and adopt those practices are, proportionally, much less than those who offer either (or both) those types of investment. Furthermore, actors who disclose their offer of art. 9 products show slightly better results than those who do just for art. 8.

6. Conclusions

This thesis aimed at investigating the situation of the Italian financial services sector in terms of compliance with the SFDR content and adoption of investment practices. After a thorough review of literature, which covered many aspects of sustainable finance with a particular focus on the SFDR, the empirical analysis has started. The scope which the research on FMPs and FAs has been carried out with was the one of a retail investor aiming at understanding the approach to sustainable finance of the entities which can be assessed through their websites. The information to be looked at during the inspection has been pre-defined and expressed by a set of measures. Data has been collected in an ad-hoc file and, after the end of the research, it has been extracted and properly analysed to reveal different pictures of the Italian Financial Sector. This thesis, therefore, showed the proportion of FMPs and FAs in the research sample which provided the disclosures required by the SFDR articles, both entity-level and product-level ones. Results suggest that entity-level information are more present within websites than product-level, although with some degree of variability from one article to the other. The same process has been repeated for the set of best practices and investment strategies that have been identified. The most interesting part of the research, however, came when breaking-down the outcomes of the perimeter along different criteria. Many times, indeed, the analysis evidenced how Financial Advisers and SIMs lag behind with respect to the other categories of actors in terms of SFDR content disclosures and adoption of good investment practices and principles. At

the same it has not been possible to distinguish a clear pattern between asset sizes and disclosure. Finally, putting together data from different sources, further relationships have been created, like disclosure of specific types of financial products as defined by the SFDR and the associated investment style.

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