CAP_2 **Position**

CO2 reduction in portfolios from a regulatory perspective

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It is not always so easy with regulation. What was well-intentioned on the part of politicians can sometimes lead to a certain amount of frowning on the part of investors in practice, as the still relatively new regulations do not always have the necessary degree of maturity that investors would like to see. A good example is the EU Disclosure Regulation. The basic idea behind the Disclosure Regulation is easy to explain: in principle, it is about creating incentives to channel as much capital as possible into areas that enable or promote a sustainable economy. The Disclosure Regulation helps to achieve transparency about the ESG characteristics of portfolios. This achieves two objectives. On the one hand, it is about preventing so-called "greenwashing". On the other hand, it is also about showing investors various investment options in as transparent a manner as possible and supporting their decision-making. This sounds sensible and plausible, but the pitfalls lie in the details.

The EU Disclosure Regulation

There are currently three different categories of investment products under the Disclosure Regulation. The least ambitious category comprises so-called Article 6 financial products. Here, the extent to which sustainability aspects are part of the investment decisions must be disclosed; it must also be shown to what extent sustainability risks exist in the portfolio that could have a negative impact on the performance of the portfolio. However, this transparency under Article 6 does not require that the assets held in the portfolios themselves take sustainability aspects into account to a high degree; it is really only a matter of creating transparency with regard to the content, but not a specific form of content. The situation is different for the other two categories, Article 8 and Article 9 funds. Here, the requirement is not only to create a high level of transparency about the securities held in the portfolio and their ESG characteristics, but also to formulate increased requirements for the content and structure of the portfolios.

Greenbleaching or Greenwashing?

The difference between Article 8 and Article 9 financial products is multifaceted and cannot be explained conclusively in a few words. For years, whole armies of auditors and lawyers have been trying to get to the bottom of the meaningfulness of directives, detailed regulations and guidelines as well as commentaries and often revision-prone assistance from the EU in this context. In principle, however, Article 8 financial products may advertise that they have sustainable characteristics, while Article 9 financial products actually aim to achieve comprehensive sustainable objectives. If a fund in turn seeks an Article 9 classification, the requirements for the content and structure of the product increase significantly, which in the past has meant that asset managers have often avoided classifying and marketing their portfolios as Article 9 financial products in order to avoid potential disputes. In recent years, this has repeatedly led to the rather curious situation where asset managers have systematically structured portfolios that could have been classified as Article 9 financial products without any doubt if they had also claimed that the financial product was also intended to pursue sustainable goals. Instead, it was left with an Article 8 classification, which in turn led to the interesting and curious accusation of "greenleaching" - the counterpart to greenwashing, so to speak, and in both cases not welcomed by the EU.

The technocratic view of regulation

From a perhaps somewhat fundamental and economically motivated perspective, one can certainly take a critical look at EU regulation in the context of the Disclosure Regulation. This is because the legislator actually seems to believe that real economic effects are created by restructuring portfolios. There is no other explanation for the fact that financial products are differentiated according to whether they have sustainable characteristics or even sustainable objectives. The assumption that sustainable goals can be achieved in the real world by carrying out transactions on the secondary market obviously resonates here. This is a more than bold thesis. When reading the relevant texts, one sometimes gets the impression that the authors of the regulatory requirements are actually subject to the implicit misinterpretation that transactions on the secondary market have allocation effects. This is at best only indirectly and marginally the case - ultimately only ownership structures change; for every seller there is a buyer, for every buyer there is a seller. The company is largely indifferent to these transactions. Of course, it could be argued that collective sales of positions lead to falling share prices and thus have a long-term effect on the cost of capital. This would then actually have a certain allocation effect over many years - albeit in an undesirable direction. This is because the cost of capital would then rise, especially for those companies that have the greatest need for transformation, but also the greatest positive leverage on ESG issues. This is completely absurd; the implementation of the EU regulations does not directly promote any of the desired effects and cannot possibly achieve any objectives directly, but indirectly makes access to the capital market more difficult for companies that actually need the best possible access to the capital market from a transformation perspective. To put it in a nutshell: If one day Article 9 financial products are only held by software companies in their portfolios because they perform particularly well from an ESG perspective, these companies will no doubt be delighted in view of their low refinancing costs, while at the same time steel and cement companies will run out of financial breath to cope with the necessary transformation requirements. It is a little surprising that this is not discussed more often.

CO_2- reduced portfolios: Article 8 or Article 9?

This fundamental criticism of EU regulation has always been a motivation for CAP2 to do things differently. Instead of relying on changes in portfolio structures that only have an accounting effect, CAP2 makes it possible to achieve a real impact in the real world by reducing CO2 emissions to the extent that you are responsible for them. And not in accounting terms, but in real terms through the retirement of European emission allowances. The question now arises as to how financial products that implement this service should be classified from a regulatory perspective. This depends on how the asset manager wishes to position the financial product. If the asset manager's clearly defined objective is to achieve a reduction in CO2 emissions, there is no way around an Article 9 classification (even if the asset manager does not want this - it is then clearly and inevitably an Article 9 financial product). But then the asset manager must also "submit" to all other requirements for Article 9 financial products, unless the portfolio structure is compatible with requirements for an EU-defined Paris-aligned benchmark - in which case there would actually be a large degree of freedom in portfolio construction. However, most portfolios that implement the CAP2 service deliberately do not strive for compatibility with strict climate-specific EU benchmark requirements, so that the theoretical possibility of an Article 9 classification without full consideration of other Article 9 requirements beyond climate-relevant CO2 issues is only of a theoretical nature. For this reason, an Article 8 classification is a target-oriented and sensible alternative for many asset managers. There is nothing to prevent this as long as CO2 reduction is not described as a specific sustainable objective of the financial product, but as a characteristic (possibly alongside other characteristics) of the financial product.

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