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Talking SFDR with Fund Managers, Credit Analysts and Private Debt Lenders: Perspectives from ELFA's SFDR Workshop

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Executive Summary

- September 2022 was ELFA's designated "SFDR Month", comprised of a series of events designed to explore emerging market practice with respect to implementation of the regulation.
- This report summarises key takeaways from our ELFA SFDR Member Workshop, which facilitated discussion between investors on the practical implementation of SFDR for their funds.
- Participants exchanged insights and experience in three different breakout groups: "SFDR in credit analysis" for credit analysts, "SFDR in fund creation" for fund managers and ESG specialists, and "SFDR in private credit" for private debt lenders.
- Participants noted that asset managers are taking different approaches to aspects of implementation, for example consideration of principal adverse impacts in investment decisions and the adoption of single and double materiality concepts.
- There is currently a broad set of approaches for Article 8 funds in the market that 'promote' environmental or social characteristics; in particular, most funds in the marketplace currently do not consider or report the principal adverse sustainability impact indicators (PASIs) for their Article 8 funds.
- There are challenges with obtaining and using the PASIs in credit managers' investment processes; for example, there is a lack of borrower disclosure on these data points in the leveraged finance market, and data can be backward-looking even if there is corporate disclosure, there is also a lack of coverage from external data vendors, and the relevance and usefulness of such indicators as a tool to assess impact is debatable, varying from company to company.
- One benefit of the SFDR PASIs reporting template is its potential to standardise data, as data standardisation, in general, continues to be desired by investors as ultimately good comparability of data across companies allows for historical and peer analysis and facilitates a comprehensive ESG assessment.
- In addition to the mandatory PASIs already embedded in existing ELFA ESG Fact Sheets, ELFA will incorporate four additional voluntary PASIs in its next annual update of the ELFA's ESG Fact Sheets Series relating to carbon emission reduction initiatives, anti-corruption, anti-bribery and whistle-blower protection policies.
- To strengthen borrowers' contractual commitments to disclose ESG data to lenders within loan documentation, lenders can either (i) include additional language within existing information undertakings which specifically highlights that information may be requested to enable lenders to comply with applicable sustainability requirements and/or make sustainability disclosures, including pursuant to any relevant, specific regulations such as the EU SFDR, or (ii) include a new undertaking (a) specifying the particular ESG and sustainability information that the borrower is required to provide to lenders and/or (b) providing that lenders may request information that is necessary or desirable to enable them to comply with specified sustainability regulations and requirements, including to enable them to make the relevant and appropriate PASI disclosures.

Introduction

September 2022 was ELFA's designated "SFDR Month", during which we held two key events with market participants to discuss the implementation challenges of the EU's Sustainable Finance Disclosure Regulation (the EU SFDR). The first was hosted by Latham & Watkins, and member of ELFA's Expert Panel, part of our Partner Programme.

At the event, participants discussed the practical steps of classifying a debt fund under Article 8 of the EU SFDR, the accompanying disclosure and reporting obligations and how to navigate the lack of data available from leveraged finance borrowers to facilitate compliance. The second event was an SFDR Member Workshop where members discussed and shared valuable insights and experiences on the practical implementation of SFDR for their funds.

By way of background, the EU SFDR lays down harmonised rules on transparency for financial market participants and financial advisers regarding the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability-related information on certain financial products.

In-scope financial products which promote, amongst other things, environmental or social characteristics or have sustainable investment as their objective will have to comply with more granular requirements than other types of financial products.

In conversation with Fund Managers, Credit Analysts and Private Debt Lenders

Article 8: How are environmental or social characteristics promoted?

The EU SFDR makes a distinction between Article 8 and Article 9 products.

Participants focused their discussion on Article 8 funds as most investors who attended the workshop currently manage one or more Article 8 funds within their organisation. Participants noted a wide range of approaches adopted for Article 8 funds within the marketplace and shared how they interpret the "promotion" aspect of their Article 8 fund.

Some investors noted that they use their proprietary ESG impact or ESG risk ratings as a tool to select investments. Others use carbon intensity as an indicator to promote environmental characteristics, often using a market index as a performance benchmark. Other apply a more thematic approach by only financing clean energy business activities.

An Article 8 product is a financial product which "promotes, among other characteristics, environment or social characteristics or a combination of those characteristics, provided that the companies in which the investment are made follow good governance practices".

An Article 9 product is defined as a financial product that "has sustainable investment as its objective". A sustainable investment means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular, an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance. [1]

[1] Source: Regulation (EU) 2019/2088 of the European Parliament and the European Council of 27 November 2019 on sustainability related disclosures in the financial services sector. Online at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&-from=EN

Do investors distinguish between "sustainability risks" and "principal adverse impacts", as defined under the EU SFDR?

The EU SFDR makes a clear distinction between sustainability risks and principal adverse impacts. It defines "sustainability risk" as an ESG "event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment" (this is also known as 'single materiality'). This is in contrast to the concept of "principal adverse impact" (also called "double materiality"), which intends to capture the impact of investment decisions and advice that result in adverse effects on sustainability factors.

So, in essence the double materiality concept relates to the negative impact of an underlying investee company on sustainability factors where sustainability factors refer to environmental, social and employee matters, respect for human rights, anti-corruption, and anti-bribery matters.

As such, the concept of "sustainability risk" applies to the value of the financial product, whereas the assessment of a "principal adverse impact" applies to the underlying investee company.

Participants discussed whether they differentiate between "sustainability risks" and "principal adverse impacts" within their own investment process. Participants agreed that these two concepts were vastly different from each other, but not everyone was using both in practice to the same extent – yet.

One investor mentioned they used double materiality across their entire platform, whilst others were still only using the single-materiality concept. A few investors said they use both within their organisations.

Participants also discussed the EU SFDR Article 4, which requires consideration of principal adverse sustainability impacts in investment decisions at the firm level. It seemed that some participants were not applying Article 4 at the firm level yet, but some investors were applying it at the fund level.

When discussing how investors consider principal adverse impacts in their investment decisions, there are several different approaches. One investor uses its proprietary SDG[2] scoring framework. This framework is a tool to assign a score of impact for a particular investment. It assesses positive and negative SDG contributions within an investment portfolio. It considers how a company positively or negatively impacts each SDG, with scores ranging from highly negative (-3) to highly positive (+3) impact.

Another investor commented that their firm assigns investments both a risk and an impact score, using external data vendors where possible.

Principal adverse sustainability impact indicators (PASIs)

Under the EU SFDR, there is a mandatory reporting template for the statement on considering principal adverse sustainability impacts. Mandatory reporting items include the principal adverse impacts (with a list of 18 mandatory indicators and a list of voluntary indicators), actions taken in relation to the principal adverse impact, and historical comparisons.

Participants learned at the Latham & Watkins seminar that most funds in the marketplace do not currently consider or report the PASIs for their Article 8 funds. Workshop participants discussed the relevance and usefulness of these indicators. One investor highlighted the lack of borrower disclosure on these data points, and another mentioned that even if investors obtain some of this data, e.g., carbon emissions data, this data can be extremely backward-looking.

It remains a challenge to get data that are indicators of driving change. One investor applauded the effort for standardisation and said that it is useful to investors and borrowers alike, especially for ESG metrics that are common and relevant for companies across different sectors. For investors, a good level of comparability across those data points allows for a more comprehensive ESG assessment, including historical and peer analysis.

"The PASIs are not the best tool to address impact"
– Investor participant in ELFA's SFDR Member Workshop

[2]The Sustainable Development Goals (SDGs) were adopted by all UN member states in 2015 as part of the 2030 Agenda for Sustainable Development. Collectively, these 17 goals, with 169 underlying targets and over 200 indicators, are to be achieved by the year 2030 and aim to "free humanity from poverty, secure a healthy planet for future generations, and build peaceful, inclusive societies as a foundation for ensuring lives of dignity for all". Although the SDGs are part of an intergovernmental agreement, they formally call upon the private sector to contribute to their achievement.

An investor also highlighted that there are practical challenges with the data quality of external vendors and, more importantly, coverage of borrowers in the loan and private markets is effectively non-existent.

Given the lack of borrower disclosure on these data points, one investor highlighted the qualitative approach that its firm instead applies to the principal adverse impact indicators.

In the breakout session with credit analysts, one analyst raised the concern that market participants may be at risk of missing the ultimate objective of sustainable investing as there is too much focus on reporting, measurement and quantification of ESG factors. Another credit analyst mentioned that some PASIs are not relevant for certain companies, and some need to be understood in the context of the company.

"If you have a company that is [in a] historically male dominated [industry], for example a mining company, would you be surprised that most employees are male? We need to accommodate for that and allow companies to improve. Our job is to identify what risks there are and understand how they are mitigated."
– Credit analyst participant in ELFA's SFDR Member Workshop

Regarding what comes next, one credit analyst mentioned that once a more complete data set is available, it will be more helpful to compare data over time and against peers; however, this is not possible currently.

Participants in the private debt group discussed the sustainable investment definition within the context of Article 8 and the difficulties of obtaining PASIs within private credit. An investor suggested that it can be more beneficial to engage an external data provider to work with a borrower to report and assess certain data than doing this in-house (through a credit manager's own deal team) to avoid the credibility challenge of internally scoring the same borrower.

Another topic raised in the private debt session was the list of voluntary indicators managers can select to report on. One investor suggested it would be helpful if investors could collectively determine which voluntary indicators to choose. In this way, all managers are requesting the same data points from borrowers so as a result it will be more likely that this data will be provided. ELFA has been working on this, and shortly after the workshop, members agreed on four such voluntary PASIs relating to carbon emission reduction initiatives, anti-corruption, anti-bribery and whistle-blower protection policies. ELFA will incorporate these voluntary PASIs in its next annual update of the ELFA's ESG Fact Sheets Series.

Information undertakings by borrowers in loan documentation

Existing loan documentation may already include a general catch-all disclosure undertaking by the borrower, and this may, in certain circumstances, be sufficient to cover the information that a fund may want or need to obtain from a borrower to be able to make its own PAI disclosures under the SFDR.

However, to the extent any such undertaking is qualified by "reasonableness", there is a concern that particular information requests, which may underpin a borrower's ability to make appropriate PAI (or other sustainability) disclosures, may not always be considered "reasonable". Therefore, asset managers can consider the following approaches:

1. include additional text within any information undertakings in the loan documentation, similar to the following: "…including, but not limited to, such information as may be reasonably required to enable the Agent or any Lender to make such disclosures [in respect of principal adverse impacts under the [SFDR] / [in accordance with applicable laws, regulation, standards or guidance relating to ESG and/or sustainability] as the Agent or such Lender may consider necessary or desirable."; or

2. include a new undertaking specifying the particular ESG and sustainability information that the borrower is required to provide to the Agent/Lenders to enable them to make PAI disclosures. The specific information requests would presumably be based on the data points specified in the PAI Annexes to the Delegated Regulation but would likely need to be negotiated with each borrower on a case-by-case basis.

Conclusion

Whilst the discussions under our partner program and our SFDR Member Workshop provided significant value to participants through the exchange of experience and knowledge amongst ELFA members, many implementation challenges remain. These outstanding questions are relevant for smaller credit managers who need further clarity to assist them with devising an appropriate strategy thus enabling them to overcome some of the practical challenges that have been identified above. We intend to continue these discussions through our various forums and will also continue to support industry initiatives and update our own resources to reflect the evolving needs of leveraged finance investors across the various markets and asset classes.

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