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SUSTAINABLE INVESTMENT STRATEGIES

AIAF ESG Expert Group | Viewpoint by

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The EU's Regulation on sustainability-related disclosures in the financial services sector (the SFDR) was published in December 2019 and forms part of the EU's package of measures relating to Environmental, Social and Governance (ESG) issues. The aim of this new regulation is multiple:

1. creation of transparency and standardization on sustainable investments
2. Allow the comparability of investments
3. Put order in the sustainability investments
4. Create a single classification of the investments
5. Address all the players to be more focused on the sustainability investments and related risks
6. Avoid the greenwashing

Definition of sustainable investment

To achieve this goal an important milestone has been done by introducing in the article 2 the definition on Sustainable investment that recites: "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".

This is a clear and comprehensive expression that enclose the main subjects of the sustainability, "Environmental, Social and Governance". We can divide the definition in two parts: in the first, it is declared the objectives of the investments (environmental or social), in the latter, there are the mandatory conditions to be considered sustainable (governance and harmlessness). If we are used to talk about how an investment is able to achieve a sustainable target, this rules overturn this conception, introducing the risk that the not implementation of the sustainability standard can create damage to reach the targets of EU Action plan, and defining in this way the "Sustainability Risks".

The classification of sustainable investment

This direction is also expressed very well within the two key articles that categorize sustainable investments:

- **Article 8**: Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following: (a) information on how those characteristics are met; (b) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.

- **Article 9** Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following: (a) information on how the designated index is aligned with that objective; (b) an explanation as to why and how the designated index aligned with that objective differs from a broad market index.

In other words and simplifying, the SFDR classify product in two types, SRI (art, 8) and Impact (art.9), defining all the other products in the art. 6. It is now up to the financial market players (FMPs) to define for each product which article refer to and be appropriate. It is not an easy job because the industries in the recent years has been based his classification with the seven recognized ESG/SRI Strategies: Sustainability Themed Investment, Best-in-Class, Norms-Based Screening, Exclusion/negatives screening, Integration of ESG Factors, Impact Investing and Engagement and Voting. In many cases each investment strategy pursues more than one strategy and combines the strategies together. Eurosif has tried to assign for each strategies the corresponding correct classification and has also underlined the important that no quantitative or detailed minimum requirements for products in the SFDR are defined, creating some uncertainty and opacity in the classification.

Reasonably just the Sustainability Themed and the Impact Investing can be complaint to the art. 9 (dark green), only if their portfolios is entirely strictly invested in these strategies. All the other SRI strategies can be identified in the art.8 (light green). As we mentioned before, the "good governance" is an implicit requirement for Article 8 and 9, as products also have to demonstrate that the portfolio is invested in companies following good governance practices. In other word, the application of this strategies is condition sine qua non to classify a product in one of the two articles.

The SFDR regulation and in particular the definition of art. 8 and 9 has arrived as a sort of "safety car", re-compacting the group of the FMPs and get them back on the same track. In the race of recent years, the main players have gone alone scrambling to define and outline their own sustainability strategies and own classifications. The SFDR allows the lagging players to get close to the leaders' players creating a new "start" for the sustainable investments.

The main concerns in the application of this regulation are the short timeline and vagueness on several fundamental details that are generating misunderstanding, confusion, and concerns in the industry. Some FMPs are working hard and rapidly to try to meet the requirements, others are asking to postpone the application of the Regulation. The lagging players could benefit in the shortening of the distance from the leaders, but if they are not very and well-structured to cope of the standards of the regulation, there are a serious risk of green washing, in order to comply with the deadlines, generating more mistakes and misalignments. The risk of organizations to not be able to comply on time is still existing and concrete as well as the risk of high financial and operational costs for the industry.

The quality of the data

On the other hand, it is incontestable that there are many difficulties from the industry to calculate the data not having a standard methodology, sufficient figures and a wide dispersion in the same ESG values.

The authorities are aware of these operational risks and in fact, in the course of 2021 they were forced to postpone the application of the RTS twice. On 4th of February 2021 the three European Supervisory Authorities (EBA, EIOPA and ESMA, together ESAs) published a first draft RTS (regarding disclosure standards related to Environmental, Social and Governance (ESG) factors under Regulation (EU) 2019/2088 on sustainability reporting in the financial services sector (SFDR). After that, in July, the European Commission asked to postpone the application to July 2022 (from January 2022) and the same request has been done on 25th November by European Commission that has postponed again the date to the January 2023 after the publication of the second final draft of RTS on taxonomy-related disclosures.

In the announcement it is clear that the European Commission is aware on the problematic implementation of the regulation and explain clearly that the deferment is "due to the length and technical detail of those 13 regulatory technical standards, the time of the submissions to the Commission, and to facilitate the smooth implementation of the delegated act by product manufacturers, financial advisers and supervisors".

Conclusion

Extending the timing of application of the RTS is undoubtedly a healthy and shared choice, especially if you want to avoid a race against time from the FMPs, the data provider and all the actors that can only affect the final result and the achievement of objectives of EU Sustainable Finance.

It is very interesting, at the same time, the infographic published by Eurosif on 7h of December where they "want to raise awareness of the misalignments and inconsistencies that may result from the different implementation sequences of the sustainable finance requirements. These sequences may lead to more confusion rather than help the process of implementing the EU sustainable finance agenda." While it seems necessary to move the dates of application of the RTS standards, it is important to maintain a certain harmony and balance between the various deadlines in the coming years. Returning to the automotive metaphor, there is an awareness of the goal we want to achieve. However, it is in the hands of the authorities to build a strong and stable playing field and define the correct and reasonable rules of the game.All the players will have almost 1 year to set up well their "cars" to be again present and competitive in the starting line of this Sustainability race.

This article is current as of the date of publication and does not necessary reflect the present state of law or relevant regulation.

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