

Race to comply with SFDR and taxonomy rules

Point of view

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Executive summary

The sustainable investment and financing landscape is set for a redefinition of sorts as the Sustainable Finance Disclosure Regulation (SFDR) and EU taxonomy regulations take effect.

Asset managers (AMs) would be at the forefront of this transformation and see significant overhaul across business functions, including aligning select portfolios to the EU's environmental, social and governance (ESG) objectives, as well as in the degree of ESG integration, and enhanced entity and product-level public disclosures.

In the milieu, we note a certain degree of caution across AMs. Our conversations indicate they are concerned about low taxonomy-level alignment across their sustainable portfolios, while the jury is out on the minimum degree of alignment to justify an Article 9 classification. We also see multiple instances where they are evaluating ways to upgrade Article 6 and Article 8 funds. A few small and mid-sized AMs, though, are in wait-and-watch mode.

AMs also face significant challenges pertaining to the overall data infrastructure needed to comply with the regulations. These challenges are further compounded by limited in-house bandwidth, lack of end-to-end market solutions, and regulatory ambiguity.

We feel that while compliance with SFDR and taxonomy regulations can be challenging in the near term, AMs can leverage these requirements to differentiate their investment research process and demonstrate the depth of their ESG capabilities to asset owners. AMs can also use these regulations to enhance multi-dimensional ESG integration, bolster investor perception, build granular data sets, strengthen ESG monitoring, and improve ESG engagement.

1. EU sustainability rules kick in, steep regulatory asks from AMs

The EU is in the midst of a string of sustainability-linked regulations that will come into effect over 2021-23. Of these, SFDR and taxonomy are two critical initiatives that will redefine sustainability-oriented investment management and pave the path for standardised sustainability disclosures.

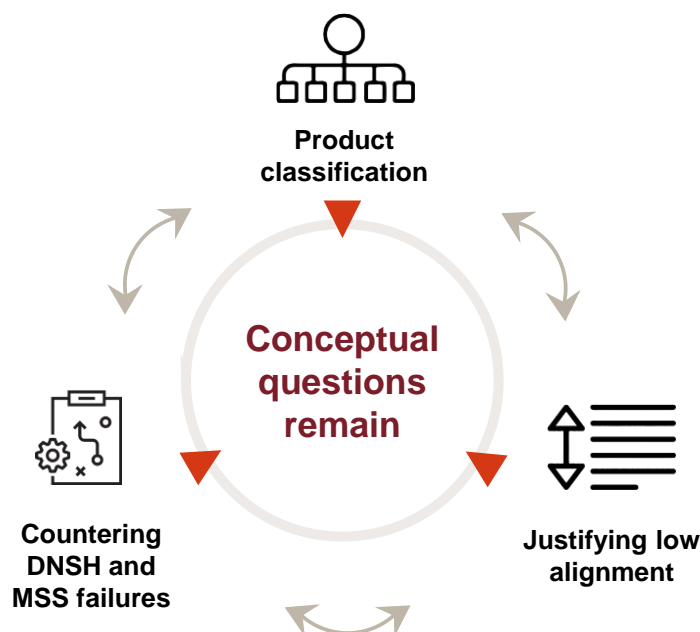
- **EU-wide standardised classification across sustainable activities will address greenwashing:** The taxonomy regulation addresses the much-needed standardisation criteria to define 'green' activities. AMs will need to assess the proportion of their sustainable portfolios that derive revenue from products/ services directly associated with environmentally sustainable activities. An activity will be fully taxonomy-compliant only if: *i)* it contributes substantially to at least one of the six environmental objectives; *ii)* it does not significantly harm the other five objectives; and *iii)* it meets minimum social and governance safeguards. The EU Technical Expert Group (TEG) has listed 70 economic activities across seven macro sectors for two climate-related objectives – climate mitigation and climate adaptation. The criteria for the remaining four objectives (pertaining to water and marine resources, circular economy, pollution prevention and control, and biodiversity) are expected to be adopted by 2021-end.
- **Sustainability disclosures will focus on commitment, impact measurement, and product labelling:** AMs have to: *i)* publish pre-contractual information on their websites on how sustainability risks are integrated into their investment processes; and *ii)* provide annual disclosures of sustainability-related data and policies at the entity and product levels. The rules are applicable on comply-or-explain basis for funds classified under Article 8 or 9. The disclosure list has around 50 Principal Adverse Indicators (PAI) for equity investments, of which 14 are mandatory and the balance opt-in. The rules outline two mandatory metrics each for sovereign, supranational, and real estate assets along with additional opt-in metrics.

The first delegated act of taxonomy regulation was adopted in 2020 and will be effective January 1, 2022. In February 2021, the supervisors released the final report comprising draft Regulatory Technical Standards (RTS) related to several disclosure obligations under SFDR. The core operative provisions of SFDR have come into effect from March 10, 2021, and full disclosure obligations related to PAIs will be effective June 2022.

2. The product conundrum: questions on classification, alignment

As the SFDR and taxonomy regulations gradually take effect, the ESG integration strategy of AMs, overall ESG product offering, client communication, investment portfolio reviews, and regulatory compliance process is undergoing significant changes. We see certain distinct trends based on our conversation with them, especially on the sustainability product front.

Strategic product decisions at stake



Key issues to address

- Classify as Article 8 or Article 9?
- Justify fund sustainability credentials
- Partial alignment – DNSH failures



Source: CRISIL GR&RS

To be or not to be – Article 8 or Article 9 fund?

The first leg of SFDR disclosures focusing on sustainability integration policies, risks, and compensation came into effect on March 10, 2021. We spoke with several AMs as we reviewed their public disclosures. We note that several of them have repositioned their existing funds under Article 8, with a few opting for considerable Article 9 funds. Many continue to evaluate ways to reposition or upgrade their Article 6 and Article 8 funds. A few small and mid-sized AMs are in wait-and-watch mode.

We also note that AMs are internally deliberating the number of opt-in indicators they would like to publish. This is crucial since this number will likely influence asset owners' perception of an AM's sustainability credentials.

Will lower revenue alignment justify Article 9 classification?

One aspect that AMs are concerned about is low taxonomy-level alignment. Based on internal studies and publicly available information on pilots conducted by AMs, we feel that overall eligibility criteria could be in the 30-40% range. Potential alignment will likely be lower. One study conducted by Adelphi and ISS ESG (covering 75 companies that are part of three major European indices) estimated the average taxonomy-eligible revenue at 22% and fully taxonomy-aligned revenue at just 2%. The jury is out on the minimum degree of alignment to justify an Article 9 classification.

Social funds face an interesting dilemma. Such funds have to deal with the fact that taxonomy is currently focused on environmental objectives, thus potentially reducing the degree of alignment for now.

DNSH failures influence overall alignment

Low degree of revenue alignment can be attributed to lack of relevant green data and the cascading effect of a single 'do no significant harm' (DNSH) check failure on the overall results of the alignment. We observe that a few AMs are seeking to use a partial alignment approach instead of an absolute yes-or-no method. In such cases, managers are likely to disclose the degree of partial alignment.

3. Tackling operational challenges

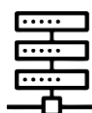
As part of the compliance process, AMs face significant challenges pertaining to the overall data infrastructure. These challenges are further compounded by limited in-house bandwidth, lack of end-to-end market solutions, and regulatory ambiguity. Timelines are strict, and AMs, therefore, have limited leeway for transforming the in-house ESG investing and reporting infrastructure that can meet expectations all regulators and asset owners.

Key compliance challenges



Data granularity

- Lack of granular data for identifying green investments
- Data from external data providers lacks comparability



Current data collation divergent from EU asks

- Long list of mandatory and opt-in indicators for SFDR compliance
- Low overlap with SASB or GRI
- Low coverage for SMEs and non-EU firms



Partial DNSH and MSS data impacting alignment

- Existing DNSH solutions are inadequate and do not fully meet EU requirements
- High resource and sector expertise needs for DNSH and MSS checks

Source: CRISIL GR&RS

Data-related challenges galore

We note that several AMs have conducted limited-scope trials focusing on taxonomy alignment and adverse impact assessment, using existing data solutions. Feedback is that existing data solutions can be a good starting point, but will require incremental analysis to meet granular taxonomy and SFDR requirements. For example,

- *Limited accuracy in green revenue and expenditure mapping* – AMs have raised concerns over: *i)* limited granular data (revenue/ capex/ opex) that can be used to identify green investments; and *ii)* limited accuracy while mapping company-level activities to the corresponding Nomenclature of Economic Activity, or NACE, codes. ESG data providers may miss out on granular information tucked away somewhere in the sustainability/ integrated reports, which can be quite valuable in mapping taxonomy alignment. In some of our discussion with AMs, we also heard concerns about the reliability of estimates, where underlying data was not reported by an investee company.
- *Limited comparability across ESG data providers* – We came across an instance where a large AM highlighted inconsistent data from two leading data providers, which, in turn, led to contrasting conclusions. This analysis covered the MSCI ACWI Investable Market Index (IMI) and focused on 23 indicators. Cross-comparability of ESG data and ratings has been a perennial issue for AMs.

We believe that AMs will need to leverage the right mix between third-party data and custom in-house research. ESG analysts will need to split the various business activities of an underlying portfolio constituent from a suitability perspective rather than the traditional product/ services/ geography approach. The new approach will need to cover an independent assessment of company disclosures, including information gleaned from sources such as Carbon Disclosure Project (CDP) and Climate Bonds Initiative (CBI). External consultants may come in for niche sectors, including real estate, forestry, and infrastructure.

SFDR, taxonomy data do not overlap with datasets more commonly aggregated by AMs

AMs have raised concerns on the quantum of data that needs to be collected to comply with the SFDR regulations. Many AMs feel that the current list of 14 mandatory indicators and 33 voluntary indicators is quite extensive and expensive to acquire. Broader metrics (such as violation of UNGC and OECD guidelines) will also require assessment of multiple sub-metrics.

SFDR-specific data points have limited overlap with the data AMs may collect based on ESG frameworks such as SASB and GRI. The degree of overlap is comparatively higher for environmental parameters, but not so much across social risks such as data privacy, cyber security, fatality, and community impact. AMs will need to bridge the data infrastructure gaps via alternative sources of data, especially as mandatory non-financial disclosures by large corporates (under the Non-Financial Reporting Directive) will delay SFDR regulations by a year.

DNSH research requires sector expertise

In order to enhance accuracy of reporting, AMs will need to spend a significant amount of time and effort in conducting DNSH and MSS checks. The assessment criteria vary across sub-industries and the information required may not be readily available. AMs will need to rope in sector expertise and may need to conduct searches covering both reported and alternative data sources, to assess portfolio constituents. In certain instances, we do see scope for some degree of subjectivity in applying the DNSH guidelines.

We believe that in order to achieve seamless compliance, AMs will require coordinated effort between ESG analysts and investment teams. While ESG analysts can drive the overall data aggregation and research process, industry-level insights from investment teams will ensure accurate assessment. Involvement of investment teams will: *i)* remove subjectivity related to the end-use of certain activities for green revenue mapping; *ii)* reverse-engineer the green revenue segment's contribution for companies with inadequate disclosures; and *iii)* identify segment-level controversies for DNSH assessment. This will ensure a standardised and consistent approach across investment teams and products.

4. AMs can leverage SFDR and taxonomy to differentiate offerings

Although compliance with the SFDR and taxonomy regulations can be challenging in the near term, AMs can leverage these requirements to differentiate their investment research process and demonstrate the depth of their ESG capabilities to asset owners. AMs can also use the SFDR and taxonomy regulations to enhance multi-dimensional ESG integration, bolster investor perception, build granular data sets, strengthen ESG monitoring, and improve ESG engagement.

Best practices roadmap

Spotlight on ESG integration



- Embed taxonomy in investment strategy to identify investment opportunities and risk
- Form independent granular view on company instead of single "rating" view

Building ESG credibility



- Build ESG datasets - alignment to climate risk and SDGs
- Strengthen credibility with asset owners to win mandates
- Build forward-looking view based on in-house research

Focused monitoring and compliance



- Selective monitoring of holdings in Article 8/9 funds to improve sustainability performance
- Drive engagement to meet commitment to net zero and PRI

Source: CRISIL GR&RS

- **Beyond regulatory compliance, spotlight on integration** – We believe the SFDR and taxonomy regulations offer AMs an opportunity to build and demonstrate enhanced ESG integration in the investment research and portfolio management process. Such deep integration will allow analysts and portfolio managers to: *i)* spot opportunities and risks across sectors as the globe transitions to a low-carbon economy; *ii)* form a granular view about a company instead of single ESG anchor; *iii)* channel allocation towards genuine green firms / transactions; and *iv)* contribute to investor education.
- **Strengthen credibility with asset owners** – Robust SFDR and taxonomy integration across the investment management process will only help AMs enhance their sustainability profile and build greater confidence among asset owners. This is extremely important as asset owners have become more focused and quite vocal about their net zero goals and sustainability allocation. In a recent survey conducted by Greenwich Associates, nearly 75% of the asset owners interviewed said they would put a mandate out of bid in case the bidder did not meet internal ESG guidelines.
- **Access to robust ESG data infrastructure** – AMs will need to complement ESG data providers with in-house datasets for robust portfolio monitoring and benchmarking. AMs can leverage SFDR and taxonomy-specific datasets to estimate the potential alignment of their portfolios based on climate goals (emission intensity goals based on science-based targets) and/ or social goals. AMs can leverage the combined application of taxonomy and forward-looking climate risk to predict portfolio-level alignment, thus promoting active sustainability risk management.
- **Monitoring holdings across Article 8 and 9 funds** – While it may not be economically prudent for large AMs to validate the entire coverage universe, we believe they will benefit significantly by closely monitoring holdings across Articles 8 and 9 funds. This exercise will help AMs understand gaps in alignment (if any), enhance engagement with investee companies, and drive such companies towards sustainability targets.
- **Effective compliance** – AMs have to collaborate with all stakeholders (companies, data providers, and third-party service providers) and peers to develop an effective sourcing strategy. This strategy should: *i)* be flexible as the regulations continue to evolve with further clarifications likely to be issued during the year; *ii)* entail an understanding of current solutions in the marketplace along with their limitations; and *iii)* have a clear understanding of potential implementation challenges.

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