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SFDR's Disclosure Challenges: How credit investors and corporate borrowers can prepare

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SFDR's Disclosure Challenges: How credit investors and corporate borrowers can prepare

Executive Summary

- The Sustainable Finance Disclosure Regulation ("SFDR") requires financial market participants ("FMPs") to disclose their ESG commitments more transparently to end-investors with a straightforward objective of preventing "greenwashing."
- FMPs, however, require clarity into how exactly they should comply with certain aspects of the SFDR.
- A final report on the draft Level 2 regulatory technical standards ("draft RTS") has still left FMPs with questions on how to adequately comply with the SFDR requirements.
- The draft RTS specifies and standardises the requirements that FMPs have to disclose under the SFDR.
- The Principal Adverse Sustainability Indicators ("PASI") detailed in the SFDR include a range of mandatory and voluntary indicators that FMPs are either required or may choose to report.
- In order to comply with the PASI requirements, FMPs will need to obtain ESG footprint data from their investee companies. However, issues can arise when such data is not available or when the data that certain investee companies are required to disclose does not align with the information that FMPs need for their PASI disclosure. This results in an information gap for those FMPs seeking to comply with the SFDR's PASI requirements.
- An FMP's ability to successfully obtain PASI-related data from investee companies is highlighted where such investees are smaller and/or have more limited capabilities to produce the requisite information.
- In this Insights report, we propose that, despite the effort involved, corporate borrowers can benefit from publishing SFDR-consistent information as they may subsequently appear more attractive to investors and this may limit the risk of having inaccurate ESG-related data attributed to them by external parties.
- More guidance is also needed for FMPs regarding the approach to inclusion of some projects (e.g., green bonds) in their PASI disclosure statement – which is not currently addressed in the draft RTS.
- As the PASI disclosure requirements apply on a "comply or explain basis" for smaller FMPs, we believe that further guidance is crucial in order to encourage and enable FMPs to comply with those PASI requirements under the SFDR.

Introduction

Market focus on sustainable investing has accelerated considerably. With continued attention on ESG investing, financial market participants ("FMPs") have sought an avenue to increase sustainable investing in a straightforward and uncomplicated manner.

Initiatives like the 2015 Paris Agreement and the 2030 Sustainable Development Agenda from the United Nations provided a roadmap to increasing sustainable investment across the financial markets. Alongside this, there has been an increased focus on understanding and tackling sustainability risks for FMPs and providing investors and corporate borrowers with clear guidelines to implement successful and effective sustainable investing.

The disclosure of accurate and relevant information to investors is an essential aspect required to support the effective implementation of sustainable investing. The Sustainable Finance Disclosure Regulation ("SFDR"), effective from 10 March 2021, imposes compulsory ESG disclosure requirements for FMPs when making investment decisions.[1]

In simple terms, the SFDR's objective is to avoid 'greenwashing' whilst creating a uniform approach for investors to follow. However, FMPs have faced challenges when navigating the complex provisions of the SFDR. As part of the SFDR, the European Supervisory Authorities (the "ESAs") published a final report on the draft Level 2 regulatory technical standards ("Draft RTS") on 4 February 2021.

The main aim of the Draft RTS is to improve sustainable investing disclosures for end-investors under the SFDR. If approved, the Draft RTS is likely to have full effect from 1 July 2022. However, further insight into how FMPs, including fund managers, should comply with the Draft RTS is still required for all parties involved. Investors will likely need to assess whether they have sufficient internal processes and resources to comply with the disclosure requirements of the SFDR.

"Acquiring data regarding an investee's overall ESG footprint is a pressing issue for Financial Market Participants."

[1] This report is based on the draft RTS published in February 2021, and no information contained herein is altered by the draft RTS published in October 2021.

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Acquiring data regarding an investee's overall ESG footprint is a pressing issue for FMPs. Among key challenges includes investee data not being readily available for FMPs, and where data is available, assessment and disclosure of the data can be complex. This raises the risk of straining the resources for smaller FMPs that may not be able to carry out extensive and complicated analyses.

It is evident that whatever their approach, FMPs will face challenges regarding the quantity and quality of data available to them from the real-world businesses in which they are directly or indirectly invested – which may ultimately drive investment increasingly towards businesses that more effectively collect and disclose such information. In this Insights report, these challenges are well illustrated by looking at the new requirements to disclose adverse sustainability indicators.

On 4 February, the European Supervisory Authorities (the "ESAs") published the final report on the draft Level 2 regulatory technical standards ("Draft RTS"), which outlines some aspects of SFDR disclosure requirements. In the time since then, it has become abundantly clear that insight is still required into how financial market participants ("FMPs"), including fund managers, should comply with the Sustainable Finance Disclosure Regulation ("SFDR"), and in particular with the requirements contained in the Draft RTS.

Although the Draft RTS is likely to have full effect from 1 July 2022, if approved, investors such as fund managers that are voluntarily complying with certain elements of the SFDR may want to assess whether they have the internal processes and resources to be able to adequately comply with the disclosure requirements.

Where an FMP is yet to decide on its approach to compliance with the SFDR, it may wish to finalise its position only after it has considered the wider obligations provided in the Draft RTS so as to ensure that it understands the scope and magnitude of the potential ongoing disclosure commitment.

For example, a decision to comply with one of the key aspects of the SFDR, which relates to disclosure of the principle adverse impacts that an FMP's investment decisions can have on sustainability factors, would require FMPs to obtain an extensive amount of data from their investee companies regarding their overall ESG footprint. Provided the data can be obtained, either directly from portfolio companies or via an external data provider, FMPs then need to assess, and in some cases carry out complex formulas, in order to disclose the extent to which they have had a negative impact on sustainability as a result of their investments.

A key issue, therefore, is what FMPs should do when investee data is not readily available and at what point an FMP is considered to have taken sufficient action that to enable them to rely on assumptions. This issue and its implications are explored further below.

What is clear is that whatever their approach, FMPs will face challenges in regard to the quantity and quality of data available to them from the real-world businesses in which they are directly or indirectly invested, a topic ELFA has been working on extensively over the past two years. Continued absence of key data may ultimately drive investment increasingly towards businesses that more effectively generate this information.

"Continued absence of key data may ultimately drive investment increasingly towards businesses that more effectively generate this information."

These challenges are well illustrated by a review of the new requirements to disclose adverse sustainability indicators.

A Review of Principle Adverse Sustainability Indicators ("PASI") disclosure requirements and related challenges for FMPs.

PASI disclosure – overview

The Draft RTS details specifications for the content, methodology and presentation of disclosures, for example: PASI statement, pre-contractual disclosure and requirements relating to periodic reporting. The Draft RTS stresses narrative reporting, meaning that FMPs must disclose their actions taken and planned, or targets set, to avoid or reduce the principle adverse impacts they have identified.

It is important to note that under the SFDR compliance with PASI disclosure requirements is optional for FMPs with less than 500 employees. Despite this optionality and given the increased focus on ESG generally and within the finance industry, we anticipate that smaller FMPs will attempt to comply with the requirements provided that they have the necessary resources to do so and once there is greater clarity from the European Commission / ESAs on PASI statements generally.

Annex I of the Draft RTS provides the draft template PASI statement, which FMPs complying with Article 4 of the SFDR will be expected to use when completing their disclosures. The PASI of investment decisions refers to where investment decisions and advice negatively impact "sustainability factors". The SFDR defines "sustainability factors" as environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

The draft template requires an FMP to include the following prescribed statement as part of its disclosure, stating that "[Name] considers principal adverse impacts of its investment decisions on sustainability factors. The present statement is the consolidated principal adverse sustainability impacts statement of [name of the FMP] [where applicable, insert "and its subsidiaries, namely [list the subsidiaries included]"]." A copy of the draft template PASI statement is set out in the Annex to the Draft RTS, available here.

Mandatory indicators

The draft template PASI statement includes 18 mandatory indicators which FMPs must consider when assessing PASI. These indicators are set out in the Annex. Included in the 18 mandatory indicators are 14 indicators that apply to investments in investee companies. In addition, there are two specific indicators that apply to investments by FMPs in real estate assets and two further indicators that apply to investments in sovereigns and supranationals. As such, taking investments in real estate assets as an example, FMPs will only need to complete the two mandatory indicators and not the remaining 16 for such investments.

In addition to the mandatory indicators, the draft template sets out 22 voluntary indicators relating to climate and the environment and 24 voluntary indicators relating to social and employee, respect for human rights, anti-corruption and anti-bribery matters, on which FMPs may also choose to report.

"The draft template PASI statement requires FMPs to complete their disclosures much like a report card on an annual basis; the indicators need to be reported based on certain prescribed calculations in relation to each of an FMP's investments."

By way of example, for investments in companies, greenhouse gas emissions must be calculated based on the levels of emissions of each investee company that the FMP is invested in, on an aggregated basis. Further, the prescribed formula cross-refers to the definitions of "scope 1, 2 and 3 GHG emissions" in Annex III of the amended EU Benchmark Regulations (Regulation (EU) 2016/1011).

The PASI calculations are, therefore, complex and cumbersome, and impose a substantial burden for compliance with the PASI statement. In addition, the draft template requires FMPs to report their aggregated performance (or "Impact") for the current year and previous year. This allows for the Impact to be tracked over time based on calculations performed at prescribed quarterly intervals, and the final two columns of the draft template provide an opportunity for FMPs to give an "Explanation" for any changes, as well as to record the "Actions taken".

Recital 5 of the Draft RTS addresses the approach to be taken for FMPs whose investments are to exclusively finance a project or type of project, such as an investment in a green bond or loan or social bond or loan (where the issuer or borrower commits to us the proceeds in a particular green or social way) or a project bond. For such investments, the ESAs have suggested that the assessment of adverse impacts should be limited "to the adverse impacts of the targeted project or type of project".

This is helpful as it means that FMPs will not need to obtain information on the indicators in relation to the issuer's or borrower's whole business – just the relevant project. We have considered the practical challenges associated with PASI reporting in the context of projects below.

When assessing these impacts for the next reference period, the Draft RTS notes that PASIs should be assessed on 31 March, 30 June, 30 September and 31 December. These prescribed timeframes could pose additional challenges for FMPs who will need to ensure that their internal ESG-related investment processes coordinate with the SFDR requirements.

Where an FMP publishes the PASI statement for the first time, the FMP need not disclose information relating to a previous reference period. This means that the earliest information relating to a reference period to be disclosed in accordance with the Draft RTS would not be made until 2023 in respect of a reference period relating to 2022.

In light of the delay to the application of the Draft RTS from January 2022 to July 2022 and the prescribed quarterly calculation requirements, it is not entirely clear whether timing for disclosure of a completed PASI statement will be postponed until after July 2023.

Practical challenges

Availability of investee company / asset data

In order for an FMP to comply with the PASI reporting obligations under the draft template, it will need to obtain details regarding each investee companies' ESG credentials (for example, amount of greenhouse gas emissions as well as for all other mandatory indicators listed in the Annex). This introduces a duty for the FMPs to obtain all relevant data from their investee companies or from third-party data providers (the Draft RTS explicitly permits the use of such providers).

Similarly, certain corporates will be under an obligation to disclose ESG-related information in their non-financial statements in accordance with the Non-Financial Reporting Directive ("NFRD").[2] However, the level and type of information that corporates are required to disclose may not neatly align with information that FMPs are required to disclose under the SFDR.

[2]On 21 April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive which would amend the existing reporting requirements of the NFRD. The effect of the proposals include extending the scope of the NFRD requirements to a broader suite of companies.

In addition, many FMPs invest in companies that are too small or outside of Europe and therefore outside the scope of the NFRD; though amendments could be made to expand the scope of companies that fall within the scope of the NFRD, this will continue to be a concern. These regulatory information gaps will require FMPs to directly engage with investee companies or to find alternative methods for obtaining the relevant disclosure information.

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As such, one of the key challenges with complying with the disclosure requirements under the PASI statement is that an FMP's ability to make the relevant disclosures is entirely dependent upon obtaining relevant ESG-related information from its investee companies.

While many FMPs will seek to rely on external third parties for investee company data, leveraged finance FMPs may find that there is less data available regarding their investments and the quality of data that is available may be insufficient. In those cases, leveraged finance FMPs will need to consider the exact alternative methods that they will rely on to obtain the necessary information.

Recital 8 of the Draft RTS provides that FMPs should use all reasonable means to identify principal adverse impacts. The ESAs have said that this may include employing external market research providers, internal financial analysts and specialists in the area of sustainable investments. The ESAs have also suggested that FMPs undertake specifically commissioned studies, use publicly available or shared information from peer networks or collaborative initiatives.

This recital alone suggests that FMPs are ultimately expected to go to fairly significant lengths in order to obtain the necessary PASI-related data. The ESAs have also suggested that FMPs may engage directly with the management of investee companies, particularly in cases where there is an insufficient level of data available.

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While it may be feasible for those larger FMPs which have the necessary resources and budget to pursue such avenues, it seems unlikely that smaller FMPs will have the internal capability or support to employ the strategies suggested by the ESAs in order to obtain PASI-related information on their investee companies and assets. ELFA has sought to address this issue by publishing sector-specific ESG Fact Sheets for investee companies to use for engagement with and disclosure to investors.

However, the concern regarding a lack of resources is not limited to matters concerning data collection. This is because even if smaller FMPs are able to obtain the relevant PASI data from their investee companies and assets, they will also need appropriate resources to analyse the data and then prepare the PASI disclosure statement. This will likely require both additional human and non-human resources such as specialist software.

Article 7 of the Draft RTS relates to the requirements that FMPs must consider when formulating their policies in order to identify and prioritise principal adverse impacts. Helpfully, this Article provides that where information relating to any of the indicators used by FMPs is not readily available, the FMP's policy should incorporate details of the best efforts used to obtain the information, which can include making reasonable assumptions.

Accordingly, the ability for an FMP to make reasonable assumptions in cases where they have been unable to obtain relevant PASI-related information from investee companies or assets may become a practical tool enabling smaller FMPs to opt-in to complying with the PASI requirements. However, FMPs should ensure that they take a proportionate approach to relying on assumptions as any over-reliance could suggest inadequate compliance with the PASI requirements.

Product categorisation

By way of background, a fund that promotes environmental or social characteristics and that makes investments in companies that follow good governance practices constitute "Article 8" or as commonly referred to by the ESAs, "light green" funds under the SFDR. On the other hand, funds that have a sustainable investment as their objective will constitute "Article 9" or "dark green" funds. As such, FMPs will also need to consider the impact that compliance with the PASI requirements may have on product categorisation under the SFDR.

This is because it is possible for FMPs to categorise their funds as "light green" solely by opting-in to consider the PASI of their investment decisions.[3] Accordingly, small FMPs should ensure that they will be able to comply with the PASI disclosure requirements and obtain the necessary PASI data from investee companies and/or assets if PASI compliance is the sole or key basis under which they have applied certain SFDR categorisations to their funds.

"Small FMPs should ensure that they will be able to comply with the PASI disclosure requirements and obtain the necessary PASI data from investee companies."

[3]Recital 19, Draft RTS.

We note that there is no express requirement for managers of "light green" funds to comply with the PASI requirements. As such, while non-compliance with the PASI requirements may be possible in cases where an FMP has "light green" funds, it is questionable whether an FMP who manages "Article 9" or "dark green" funds could legitimately opt-out of compliance with the requirements.

Recital 19 of the Draft RTS provides that "dark green" funds must consider adverse impact indicators as part of their disclosures of no significant harm to sustainability objectives. On that basis, it is unlikely that an FMP managing a "dark green" fund will be able to opt-out of compliance with the PASI requirements. This is because any opting-out could potentially cast doubt over an FMP's perceived overall commitment to ESG and sustainability considerations and may also cause the FMP to fall afoul of the SFDR.

Assessment of PASI for projects

As mentioned above, in the context of investments that exclusively finance a project, the ESAs have confirmed that assessment of adverse impacts should be limited "to the adverse impacts of the targeted project or type of project". Based on the current version of the Draft RTS and given the lack of any relevant guidance, there is a degree of uncertainty amongst FMPs as to how the indicators could be applied only to projects.

> **"Based on the current version of the Draft RTS and given the lack of any relevant guidance, there is a degree of uncertainty amongst FMPs as to how the indicators could be applied only to projects."**

This seems to stem from the fact that some of the indicators clearly do not lend themselves to certain projects, particularly since the indicators are categorised as those that apply to investments in companies, real estate assets and sovereigns and supranationals. For example, it is unclear how one would calculate board gender diversity for a project or green bond issue without applying the indicator to the issuer or borrower.

A reasonable approach may simply be to apply only those indicators that are relevant to the project, even if it results in excluding the project from calculations of some of the mandatory indicators. However, as there is no guidance available on this issue, the application of the indicators to projects is clearly an area in which further clarity is needed from the European Commission / the ESAs.

Look-through principle

FMPs will also be held to account through a new concept introduced in the Draft RTS referred to as the "look-through principle". The aim is to prompt FMPs to look through to the underlying investments of, for example, collective investment undertakings and special purpose vehicles, in order to assess PASI.

> **"The aim is to prompt FMPs to look through to the underlying investments of, for example, collective investment undertakings and special purpose vehicles, in order to assess PASI."**

Unhelpfully, the ESAs state that FMPs that cannot obtain such information on the individual underlying investments of those companies, will not be considered to take into account the principal adverse impacts of their investment decisions on sustainability factors. This somewhat contradicts the notion in the Draft RTS that FMPs can disclose on a best-efforts basis to find such information under Article 7.

However, in the absence of any current guidance, this comment should be read in conjunction with Article 7 such that if an FMP cannot obtain the requisite information after it has exhausted all reasonable means, only then should it be considered to not take into account principal adverse impacts. Hopefully this is something on which the Commission will pick up and offer clarity in due course. In any event, FMPs will need to factor in the ESA's comments as part of any positive decision to comply with the PASI disclosure requirements.

As mentioned above, it is possible for FMPs to categorise their funds as "light green" under the SFDR solely on the basis that they will consider the PASI of their investment decisions. Accordingly, any FMP that has categorised their fund on this basis will need to bear in mind the look-through principle as an inability to comply with it could give rise to unintended consequences and/or limitations in relation to product categorisation.

Translation Requirement

The Draft RTS places an onerous translation requirement on FMPs. FMPs will be required to translate the summary section of their SFDR PASI statement and the summary section of the website disclosure. The summary must be provided in one of the official languages of the home Member State of the FMP, and where different, in an additional language customary in the sphere of international finance. In addition, where a financial product of the FMP is marketed in a host Member State, the summary must be provided in one of the official languages of that host Member State.

Once again, FMPs will need to consider these translation requirements as part of their decision to comply with the PASI disclosure requirements.

Considerations for corporate borrowers

As highlighted above, FMPs complying with the PASI requirements under the SFDR will be entirely dependent on the ESG-related information that their investee companies and assets publish and/or provide. This in turn gives rise to the need for corporates to consider their own approach to ESG integration and whether they want to publish or provide such information to investors or

allow investors to make assumptions and/or rely on third-party data providers. Therefore, it may be prudent for corporates to control their own narrative by publishing the relevant PASI information themselves.

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As ESG considerations are becoming more important for FMPs, and in light of the PASI requirements, there is potential that FMPs may seek out investments where accurate ESG-related information is more readily available. This is because by providing such information to investors, those corporates will assist their FMP investors to satisfy their own SFDR obligations. This in turn may make such corporates more appealing to investors.

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Similarly, certain corporates will be under an obligation to disclose ESG-related information in their non-financial statements. However, the level and type of information that corporates are required to disclose may not neatly align with information that FMPs are required to disclose under the PASI requirements. In addition to potentially becoming more attractive to investors, such corporates may benefit from publishing SFDR-consistent information in order to mitigate any risk of inaccurate ESG-related data being attributed to their businesses by investors and other third parties.

ELFA's ESG Fact Sheets can serve as a helpful starting point for corporate borrowers who seek to provide credit investors with the necessary information to comply with the SFDR.

ELFA's ESG Fact Sheets can serve as a helpful starting point for corporate borrowers who seek to provide credit investors with the necessary information to comply with the SFDR. The resources are periodically updated to account for regulatory requirements. Company advisers can refer to the Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions for more information on the issues around drafting effective ESG disclosure.

Conclusion

The Draft RTS emphasises that the PASI statement is an essential tool for achieving the objectives of the SFDR, such as to encourage investment flow from the financial services sector to companies engaged in, or transitioning, to more sustainable activities, with the aim that the EU can meet its climate change goals and become carbon neutral by 2050. Clearly, there is still a range of PASI-related questions that would benefit from further guidance and/or clarification from the Commission and/or the ESAs, including:

- timing for disclosure of a completed PASI statement and whether that will be postponed until after July 2023;
- the application of the indicators to projects and where investments are not in equity, debt, real estate, sovereigns or supranationals;
- the "look-through principle" and whether reasonable assumptions are sufficient where underlying investment data is not available; and
- confirmation that reliance on best efforts is adequate where the majority of an FMP's investments are made in companies that fall outside the scope of the NFRD (including in any revised form).

These outstanding questions are particularly relevant for smaller FMPs as further clarity should assist them with devising an appropriate strategy that will hopefully enable them to overcome some of the practical challenges that have been identified above.

As it stands, and based on the likely resource and budget constraints faced by smaller FMPs, PASI reporting may be more prominent amongst larger FMPs initially. Hopefully with further guidance on an FMP's ability to rely on best efforts to obtain PASI-related data and as market views develop, smaller FMPs may find that they are able to opt-in to PASI reporting in due course.

About the ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA's website: www.elfainvestors.com.

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