

Overview and comments on ESAs final recommendations on SFDR RTS

Introduction

Following the consultation paper of last year (see [ICMA AMIC response submitted on 1 September 2020](#)), the European Supervisory Authorities (ESAs) published their [final report](#) with recommendations regarding the regulatory technical standards (RTS) for the Sustainable Finance Disclosure Regulation (SFDR).

The ESAs propose to apply the RTS from 1 January 2022, confirming again that the level 1 text will start to apply from 10 March 2021 without the RTS (see [ICMA memo summarizing the main provisions of SFDR](#)). A statement by the ESAs is to be issued in the course of February on how to apply the level 1 text from 10 March 2021.

Regarding the RTS, it is now up to the European Commission to decide whether or not to endorse the proposal from the ESAs (decision within 3 months; possibility to deviate from the ESAs' proposal; and possible 4 weeks consultation prior the EC adoption).

Table summarizing main provisions under the SFDR

Types of disclosure	Legal nature	Scope	Where to disclose
Policies on the integration of sustainability risks in investment decisions or advice (art.3)	Mandatory	Asset managers, pension providers, insurers + financial advisors	Website
Consideration of adverse sustainability impacts at entity level (art.4): <ul style="list-style-type: none"> • Principal adverse impacts/indicators/actions • Engagement policies • Adherence to standards on due diligence, alignment with Paris Agreement (where relevant) 	Comply or explain Firms, group subsidiaries with > 500 employees cannot 'explain' after 30 June 2021	Asset managers and pension providers, insurers + financial advisors	Website
Consistency between remuneration policies and sustainability risks (art.5)	Mandatory	Asset managers, pension providers + insurers+ financial advisors	Website
Integration of sustainability risks in investment decisions or advice and impacts of sustainability risks on the returns of the financial products (art.6)	Comply or explain	AIFs, UCITS, mandates, pension product and scheme, PEPP, insurance-based investment product	Pre-contractual documents
Consideration of adverse sustainability impacts at product level (art.7): <ul style="list-style-type: none"> • Methodology integrating sustainability adverse impacts into their investment decisions 	Comply or explain By 2023 each financial product issued by firms needs to comply or explain	AIFs, UCITS, mandates, pension product and scheme, PEPP, insurance-based investment product	Pre-contractual documents
Characteristics/objectives/benchmarks of ESG and 'sustainable' financial products (art.8, 9, 10 & 11).	Mandatory	AIFs, UCITS, mandates, pension product and scheme, PEPP, insurance-based investment product	Pre-contractual documents, website and periodic reports

The final draft RTS deal with two main aspects of SFRD:

1. **Entity level disclosures** on principal adverse impacts (i.e. impact of all investments on sustainability factors).
2. **Product disclosures** (website, pre-contractual documents, periodic reports): applicable to products with either environmental or social characteristics ('light green') or with sustainable investment objectives ('dark green'). This excludes green bonds, which are not part of the definition of 'financial products' in SFDR.

1. Entity level disclosures on principal adverse impacts

Summary of the ESAs final proposal:

- **KPIs:** Financial market participants will be required to assess all their investments in investee companies against 14 mandatory environmental and social KPIs (see annex below) and 2 KPIs to be chosen from the optional lists of 46 environmental and social KPIs. Only firms with fewer than 500 employees can make use of the comply-or-explain clause.
- **Sovereign bonds and real estate:** Sovereign/supranational bonds and real assets will only need to be assessed against their dedicated KPIs (2 each) and 2 KPIs to be chosen from the optional lists of 46 environmental and social KPIs.
- **Green bonds:** Green and Social bonds will have to be assessed against the 14 + 2 KPIs (i.e. recital 5): *'In the case of investment decisions where an investment exclusively finances a project or type of project, such as an investment in a green bond, social bond or project bond, the assessment of the adverse impacts of the investment decisions should be limited to the adverse impacts of the targeted project or type of project'*.
- **Date of first reporting:** The first reporting on these KPIs will need to be made in 2023. This will then need to be updated by 30 June each year with a reference period of the previous calendar year (an historical comparison of 5 years will need to be provided).

Preliminary comments:

It is disappointing to see the contested approach of quantitative disclosure at firm level retained by the ESAs because (1) financial market participants do not fully control their asset allocation (asset owners are subject to prudential requirements and asset managers are subject to clients preferences) and (2) assessing the ESG footprint at firm level is not relevant to investors as they invest via financial products and not directly in financial market participants (if and when they do, NFRD is there to provide the necessary information). Another major concern with this approach is that it relies on KPIs that are only backward looking.

If the list of mandatory indicators has been shortened compared to the first proposal, which contained 32 mandatory KPIs, implementation challenges remain:

- The KPIs are not always adapted to all asset classes yet all investments made need to be factored in. As a result, some KPIs like the carbon footprint may be prone to approximations (missing/irrelevant data or estimation).
- When the data for the KPIs is not readily available (which may often be the case) financial participants are expected to retrieve the information from issuers, make use of data providers or make reasonable assumptions (i.e recital 8 and article 7.2 of draft RTS).

2. Product disclosures applicable to ‘light’ and ‘dark green’ products (articles 8 and 9)

Summary:

The sustainability characteristics or objectives of financial products are to be disclosed in an annex to the respective sectoral pre-contractual and periodic documentation in mandatory templates and on providers' websites:

- Pre-contractual information should include details on how a product with environmental or social characteristics/sustainable investment objective meets those/that characteristics/objective.
- Information on the entity's website on the environmental or social characteristics of financial products/sustainable investment objective of the product and the methodologies used.
- Information in periodic reports specifying: (I) the extent to which products met the environmental and/or social characteristics by means of relevant indicators; and (II) for products with sustainable investment objectives, including products whose objective is a reduction in carbon emissions.
- Information in relation to the 'do not significantly harm' principle: specifying the details for how sustainable investments do not significantly harm sustainable investment objectives.

Preliminary comments:

- **Article 8 products:** The 'warning' statement for ESG products (article 8) was slightly modified. In the information on the website, it must now be made clear by default that Article 8 products 'pursue ecological or social characteristics, but do not aim for sustainable investments' (Article 34 RTS draft). Which is somewhat better than simply stating that they do not 'aim for sustainable investments'. However, there may be confusion resulting from the requirement for an article 8 product to disclose whether or not it intends to make a sustainable investment and the need to perform a 'Do Not Significantly Harm' assessment on the potential sustainable investment.
- **Article 9 products:** The definition of what 'significant harm' means is left at the discretion of asset managers but the KPIs (mandatory and optional) need to be 'taken into account'. It will be difficult for fund managers to consider all indicators when assessing the DNSH objective, as issuers are not required to disclose against these KPIs. Meeting the DNSH test may be challenging even for the existing dark green products. For instance, green bond funds need to diversify their allocation and for risk management purposes can invest up to 30-40% of the assets in corporate bonds or sovereign bonds. Conducting the DNSH test for corporate bonds will be burdensome especially for large companies given the breadth of their activities and their geographical footprint. Finally, we note discrepancies between the approach under the EU Taxonomy TEG report/EC draft technical criteria, where the DNSH test is restricted to Environmental KPIs and tailored to specific activities (and therefore more appropriate for GBs), and the ESAs' approach, with its KPIs. This could lead to a duplication of DNSH tests and potentially contradictory outcomes.

Points to be considered:

- **Categorisation of products between article 6, 8 and 9** may be an iterative process, as the consideration of KPIs and the implementation of the DNSH at product level are not yet well defined.

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Annex: ESAs' proposed mandatory KPIs to be considered for entity disclosure

Indicators applicable to investments in investee companies						
Adverse sustainability indicators	Metric		Impact [year n]	Impact [year n-1]	Explanation	Actions taken
CLIMATE AND OTHER ENVIRONMENT-RELATED INDICATORS						
Greenhouse gas emissions	1. GHG emissions	Scope 1 GHG emissions				
		Scope 2 GHG emissions				
		From 1 January 2023, Scope 3 GHG emissions				
		Total GHG emissions				
	2. Carbon footprint	Carbon footprint				
	3. GHG intensity of investee companies	GHG intensity of investee companies				
	4. Exposure to companies active in the fossil fuel sector	Share of investments in companies active in the fossil fuel sector				
	5. Share of non-renewable energy consumption and production	Share of non-renewable energy consumption and non-renewable energy production of investee companies from non-renewable energy sources compared to renewable energy sources, expressed as a percentage				
6. Energy consumption intensity per high impact climate sector	Energy consumption in GWh per millionEURofrevenueof investee companies, perhighimpactclimate sector					
Biodiversity	7. Activities negatively affecting biodiversity- sensitive areas	Share of investments in investee companies with sites/operations located in or near to biodiversity- sensitive areas where activities of those investee companies negatively affect those areas				
Water	8. Emissions to water	Tonnes of emissions to water generated by investee companies per million EUR invested, expressed as a weighted average				
Waste	9. Hazardous waste ratio	Tonnes of hazardous waste generated by investee companies per million EUR invested, expressed as a weighted average				
SOCIAL AND EMPLOYEE, RESPECT FOR HUMAN RIGHTS, ANTI-CORRUPTION AND ANTI-BRIBERY MATTERS						
Social and employee	10. Violations of UN Global	Share of investments in investee companies that have been				

matters	Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises	involved in violations of the UNGC principles or OECD Guidelines for Multinational Enterprises				
	11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises	Share of investments in investee companies without policies to monitor compliance with the UNGC principles or OECD Guidelines for Multinational Enterprises or grievance /complaints handling mechanisms to address violations of the UNGC principles or OECD Guidelines for Multinational Enterprises				
	12. Unadjusted gender pay gap	Average unadjusted gender pay gap of investee companies				
	13. Board gender diversity	Average ratio of female to male board members in investee companies				
	14. Exposure to controversial weapons (anti- personnel mines, cluster munitions, chemical weapons and biological weapons)	Share of investments in investee companies involved in the manufacture or selling of controversial weapons				
Indicators applicable to investments in sovereigns and supranationals						
Environmental	15. GHG intensity	GHG intensity of investee countries				
Social	16. Investee countries subject to social violations	Number of investee countries subject to social violations (absolute number and relative number divided by all investee countries), as referred to in international treaties and conventions, United Nations principles and, where applicable, national law				
Indicators applicable to investments in real estate assets						
Fossil fuels	17. Exposure to fossil fuels through real estate assets	Share of investments in real estate assets involved in the extraction, storage, transport or manufacture of fossil fuels				
Energy efficiency	18. Exposure to energy-inefficient real estate assets	Share of investments in energy-inefficient real estate assets				