

Sustainable Finance Disclosure Regulation - Article 6 Funds

What to consider when integrating sustainability risk into the investment decision making process?

The European Commission published the Sustainable Finance Disclosure Regulation, known as the SFDR or the Disclosure Regulation in November 2019 with an implementation date of 10 March 2021. Since then financial market participants, including fund managers and their products i.e. UCITS and Alternative Investment Funds ("AIFs"), have been assessing these requirements. On 20 October 2020, the European Commission confirmed in a letter to the European Supervisory Authorities ("ESAs") that all level 1 requirements of SFDR will become applicable from the 10 March 2021 but

the level 2 technical standards will not become applicable until 1 January 2022. Fund managers will be required to comply with the high level and principle based requirements of SFDR from 10 March 2021.

This has given fund managers and their funds time to consider the sustainability indicators and how they will integrate and measure sustainability risk in their investment decisions. To date most funds have been considering the website disclosures and the information to be included in pre-contractual disclosures under Article 3 and 6 of SFDR.

In the absence of regulatory guidance for firms to assess how to comply with SFDR, we have produced this paper as the first in a series of publications with a view to assisting funds and their managers in considering the underlying policies that they would need to have in place. This paper focuses on Article 6 of the SFDR.

Article 6 – Transparency of the Integration of sustainability risks

Article 6 requires the following:

“Financial market participants shall include descriptions of the following in pre-contractual disclosures:

- a. the manner in which sustainability risks are integrated into their investment decisions; and*
- b. the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.*

Where financial market participants deem sustainability risks not to be relevant, the descriptions referred to in the first subparagraph shall include a clear and concise explanation of the reasons therefore.”

For funds, this means making provisions for the above disclosures in the fund's prospectus. Where the fund deems sustainability risks to be relevant, it is required to not simply declare that it has integrated sustainability risks into its investment decisions, but to describe how this is achieved, and to have a policy in place that underpins that disclosure. It is worth noting that the fund does not need to be classified as an Environmental, Social or Governance ('ESG') or 'Green Fund' for this article to apply, and where the fund deems sustainability risk not to be relevant, the rationale for same must be clearly set out. For a fund with a diverse strategy that is widely marketed, it is likely that sustainability risk is and will continue to be relevant. We have set out some key considerations in integrating sustainability risk into the investment process:

Policy

Where sustainability risk is deemed relevant, funds or their fund manager, are required to disclose the manner in which those risks are assessed by the fund.

Some examples of criteria for integrating sustainability risk include:

- Exclusion or avoidance screening is often the first step in ESG integration and divestment from those exclusions is widely used. Controversial sectors such as weapons, coal and tobacco are most-frequently cited for exclusion and divestment. Funds or their fund managers also often exclude investment in fossil fuel exploration and production, alcohol, gambling and gender imbalanced boards.
- Inclusionary screening which is normally done after exclusions considers potential E, S and G factors. This could be assessing the relative ESG rating provided by data providers and a fund manager may consider selecting all companies that have a higher than average, or those that achieve a score higher than a set threshold or achieve the top ratings in each one of the asset classes.
- The best-in-class approach may also apply to different sectors and specific ESG objectives. For example you may have a criteria to select companies with a low carbon footprint or a high green agenda.
- Active ownership and engagement are also widely used in sustainability risk integration. Certain investors will actively engage in shareholder voting and may have specific agenda's to increase a companies overall ESG footprint.

Once the criteria has been agreed, the fund manager and fund should consider how to document their policy.

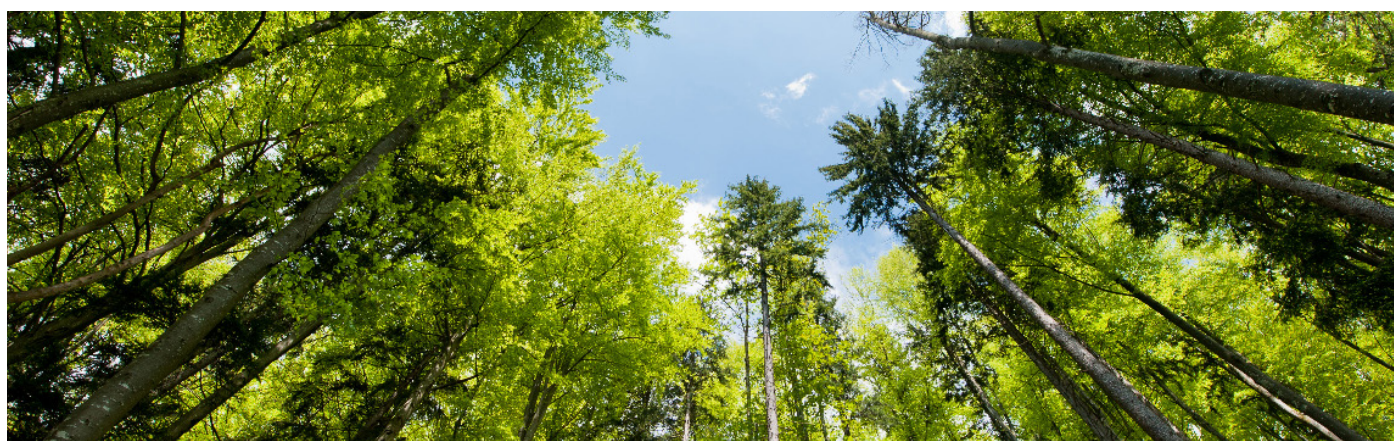
The policy should include:

- a description of the assessment process used by the fund manager to identify and prioritise sustainability factors relevant to the fund;
- the date of approval of the policies by the board of the fund or the fund manager;
- the allocation of responsibility for the implementation of the policies within organisational structure and procedures;
- a description of the methodologies to select and identify the sustainability indicators and and assess the impact of those indicators;
- an explanation of any associated margin of error within those methodologies;
- a description of the data sources used; and
- details of data obtained either directly from investee companies or from third party data providers.



Good practice:

The policy should be documented for each fund and should be reviewed and approved by the board of directors of the fund manager on an annual basis.



Website disclosure

In accordance with Article 3 of SFDR, *“financial market participants shall publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making process”*.

This statement should be based on the policy approved by the board of directors of the fund manager.

For fund managers and funds who **do not consider sustainability risk in investment decisions**, they need to state clearly the reasons why and consider whether and when they intend to consider such information in the investment decision. This should be published in a separate section titled, ‘No consideration of sustainability adverse impacts’. Reasons why sustainability risk might not be relevant could include; the fund was established for a specific purpose, the investment strategy is bespoke and has been designed to accommodate investor requirements or the fund has a short shelf life.



Good practice:

The website disclosure should be a separate section which states whether the fund manager and fund considers sustainability risk or not and it should be updated on a regular basis.

Risk Management Framework

Sustainability risk in the SFDR is defined as: *“An environmental, social, or governance event, or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.”*

In considering the Risk Management Framework there are a number of areas a fund manager and fund needs to consider in terms of integrating sustainability risk into their Risk Oversight, Risk Systems and Capability and Risk Processes.

Risk Oversight

Some key considerations include:

- **Tone from the top** – The key driver to integrating sustainability risks into a risk management framework is the attitude that the Board and Senior Management take towards the role and priority of sustainability risk, because that ultimately cascades down throughout all levels of the organisation.
- **Risk strategy and risk appetite** – A key element is the Risk Appetite statement relating to sustainability risk; how this is reviewed, approved and ultimately integrated into the decision making process.
- **Governance** – The organisation should consider its key roles, responsibilities and delegated authority relating to sustainability risk are clearly defined within the organisation.

Risk Systems and Capability

Some key considerations include:

- **Risk infrastructure** – Sustainability risk has given rise to the new EU taxonomies which will underpin SFDR. It is paramount that organisations review and update their risk infrastructure from a data perspective to accommodate this. It must be noted that the SFDR provisions apply at both fund and fund manager in respect of all financial products.
- **Resources** – Other considerations include a capability assessment and, where necessary, upskilling relevant staff, such as in the risk function and/or risk champions so as they understand sustainability risks.
- **External disclosures** – The framework must consider relevant, granular, and forward-looking data. Even though there is an abundance of ESG data and ratings, divergent methodologies across data vendors mean that the ratings assigned to each company can vary significantly.
- **Risk monitoring and reporting** – Ensuring regular reporting to key stakeholders whether through periodic reporting or reporting to the board of directors.



Risk Processes

Some key considerations include:

- How sustainability risks are **identified, assessed and monitored** is where the link between risk management and actual decision-making is most visibly made and most valuable.
- A key element of this is ensuring that sustainability risks is incorporated in the risk register and identifying the controls and processes to monitor the risk. Sustainability risks are different to traditional risk types, for instance, environmental risks tend to be non-linear in their propagation and occur over a longer time horizon. These can affect multiple risk categories simultaneously. Historical loss experience cannot be used to estimate these type of risks.

- In addition, ensuring any regulatory compliance risks and reporting requirements are identified and monitored.

Finally, the framework should support compliance to other regulations relating to sustainability and avoid duplication of effort.

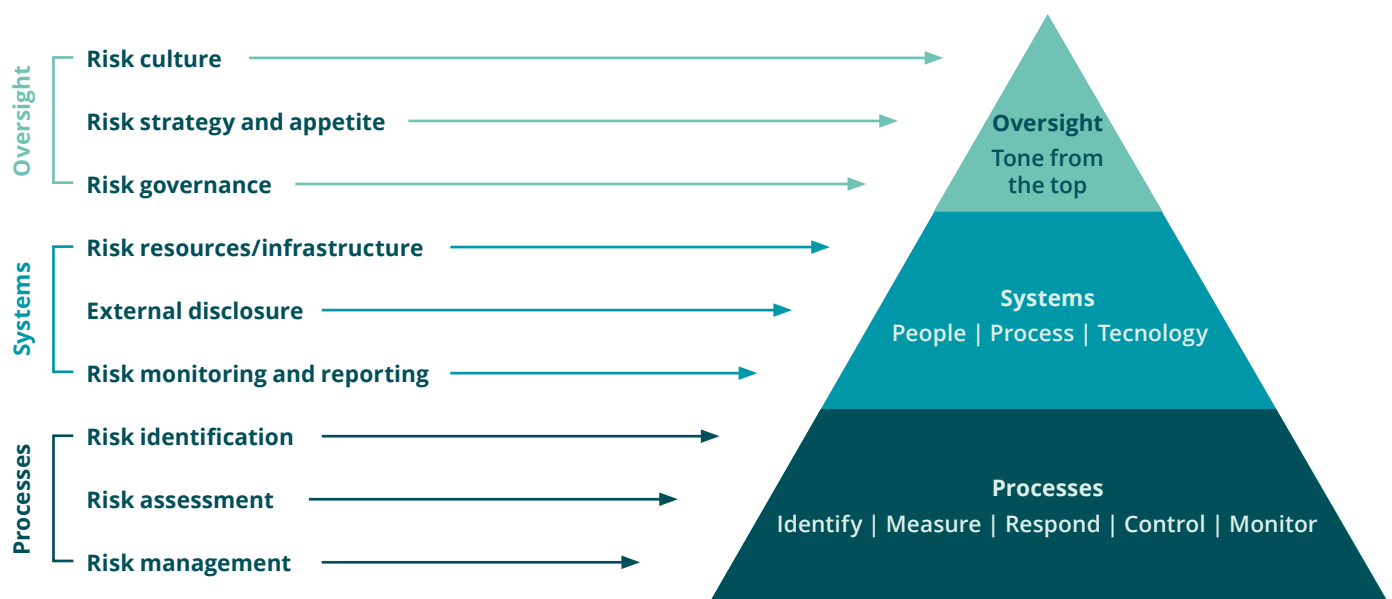
Fund managers may need support in integrating sustainability risk in their current risk management framework and as sustainability disclosure become more mainstream, board of directors will want some type of assurance that policies, procedures, risk frameworks and controls integrating sustainability risks are throughout the value chain.



Good practice:

Sustainability risk is integrated into the existing Risk Management Frameworks demonstrating linkages, dependencies and potential impacts to support decision making.

Example of risk framework incorporating sustainability risk





How can Deloitte help

We have designed a framework to support sustainability risk integration and the provision of assurance over your ESG disclosures that can support boards of directors, audit committees and management in their journey towards compliance with SFDR disclosure requirements or other ESG frameworks.

Benchmarking and gap analysis

What is it:

Independent benchmarking of your current disclosures against recommendations and/or identifying gaps in your disclosures, processes or controls and reporting privately to management and those charged with governance.

What is it used for:

Benchmarking and gap analysis provides the basis of a roadmap to ESG disclosures.

Designing and Implementing ESG frameworks

What is it:

Designing and implementing a policy and risk management framework that captures processes, controls and reporting privately to management and those charged with governance on the ESG integration.

What is it used for:

Policy and framework can be used to monitor ESG for all investment products.

Assurance over selected ESG metrics

What is it:

Private or public independent ISAE 3000 assurance over your ESG disclosures and metrics.

What is it used for:

Assurance over ESG disclosures and metrics can be a useful starting point on a path to SFDR disclosure compliance or provide investors with confidence you have integrated sustainability risk in investment decisions.

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