CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

SFDR

Part 5: Principal Adverse Impacts

Monitoring, measuring and reporting how investments affect the environment and our society

JUNE 2023

Marketing communication

Over the past two decades, sustainable investing has grown from a specialist investment topic into a mainstream concern at the top of investors' agendas. Driven notably by the recognition that consideration of ESG factors can lead to more comprehensive risk management and help in the identification of pockets of growth, investor demand for sustainable investment strategies has grown substantially and been met by a large supply of financial products. To support financial flows into sustainable activities, while also setting standards for the ever-growing number of sustainable investment products, the European Union has developed a set of directives and regulatory standards.

Amongst these, the Sustainable Finance Disclosure Regulation (SFDR) was introduced to increase and harmonize the disclosures made by financial market participants in regard to their investment products and their own operations, thus supporting their transparency and making it easier for investors to understand, evaluate and compare products.

The implementation of SFDR took place in several phases:

- Level 1 of SFDR came into force in March 2021 and set out the regulation's principles and broad guidelines.
- SFDR Level 2, the Regulatory Technical Standards (RTS), was introduced in June 2022 and came into force in January 2023. These RTS included more granular disclosure requirements, including the Principle Adverse Impacts (PAIs), as well as and guidance on implementation.

Understanding Principal Adverse Impacts and their objectives.

A cornerstone of SFDR is the concept of double materiality. This concept describes two essential considerations in sustainable investing:

- Investments can be subject to sustainability risks, such as climate-related or social risks. The realization of these risks can negatively affect investments and their value.
- Investments can in turn have negative repercussions on the environment and society.

Principal Adverse Impacts (PAIs) capture the second leg of the double materiality concept: the potential negative impacts that investments can have on the environment and society. In other words, **PAIs are the potential negative effects, whether material or likely to be material, of investment decisions on sustainability factors.** By way of example, let's take the decision to invest in the stock of an energy-producing company which primarily operates in the space of fossil fuels and has no intention of pivoting to less CO2-intensive power sources. A key adverse impact here will be the greenhouse gas emissions of the company, which of course have significant consequences for the climate and the environment in general.

SFDR outlines 64 adverse sustainability indicators to measure such PAIs. Of these, 14 are currently mandatory[1] and applicable to corporate investments, 2 to sovereign issuers[2]. They are outlined below.

1 - On a comply or explain basis.
2 - Other indicators apply to asset classes such as real estate. They are not covered herein.

Adverse sustainability indicators applicable to investments in investee companies

Climate and other environment-related indicators

Greenhouse Gas emissions	1. GHG emissions
	2. Carbon footprint
	3. GHG intensity of investee companies
	4. Exposure to companies active in the fossil fuel sector
	5. Share of non-renewable energy consumption and production
	6. Energy consumption intensity per high impact climate sector
Biodiversity	7. Activities negatively affecting biodiversity-sensitive areas
Water	8. Emissions to water
Waste	9. Hazardous waste and radioactive waste ratio

Indicators for social and employee, respect for human rights, anti-corruption and anti-bribery matters

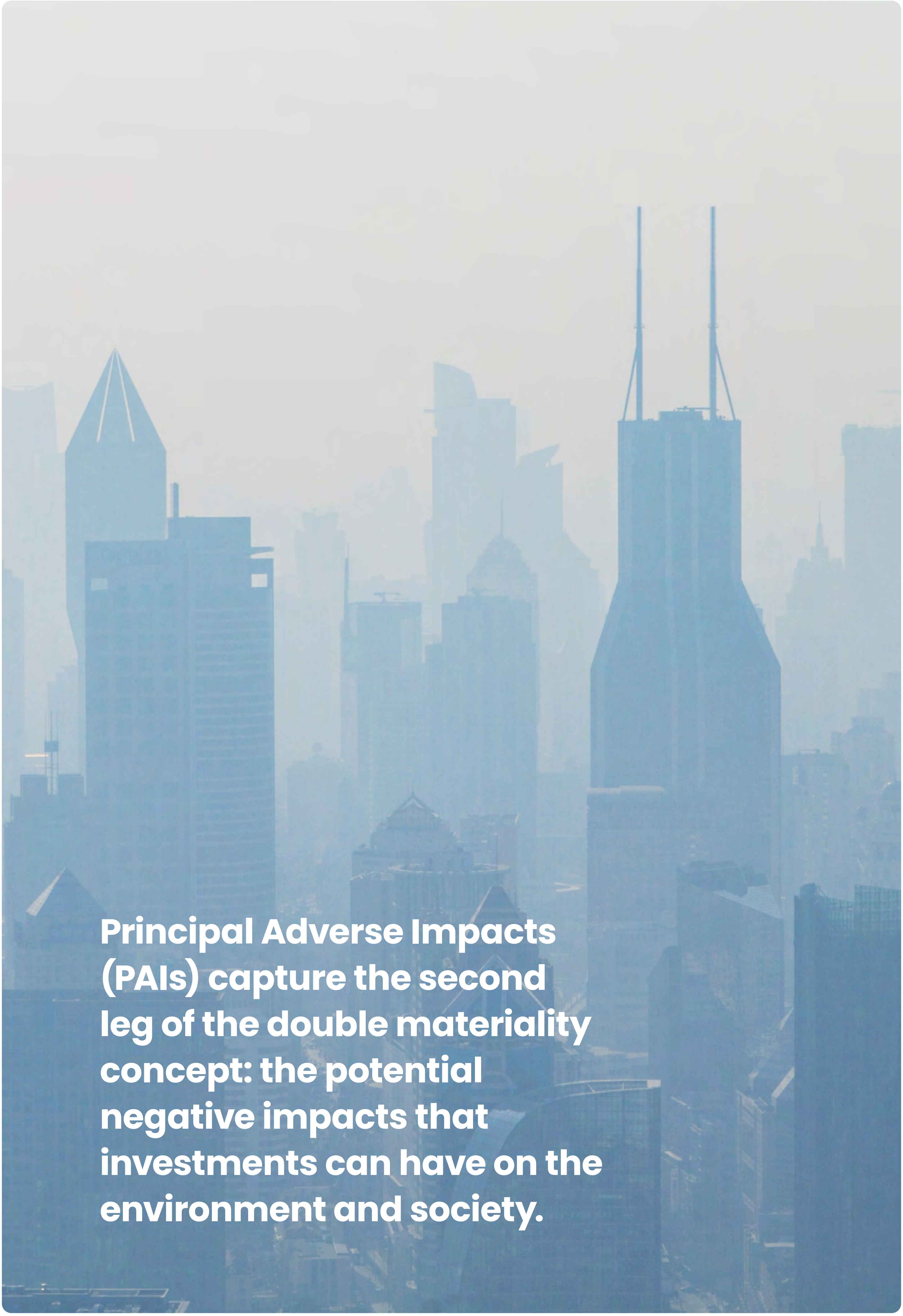
Social and employee matters	10. Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises
	11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises
	12. Unadjusted gender pay gap
	13. Board gender diversity
	14. Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons)

Adverse sustainability indicators applicable to investments in sovereigns and supranationals

Environmental	15. GHG intensity
Social	16. Investee countries subject to social violations

Source: EUR-Lex, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02022R1288-20230220&qid=1685370524813

Amongst the objectives driving the introduction of this framework of indicators are higher levels of disclosure of sustainability metrics, which in turn should foster greater awareness of the repercussions of investment decisions on the environment and society, as well as greater ease for investors when comparing investment products and financial market participants such as asset managers. In fact, PAIs apply at two levels - entity level and product level, as explained hereafter.



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Implementation at two levels.

Similarly to other elements of SFDR, PAIs are applicable at two levels: entity level and product level.

PAIs at entity level

SFDR's Article 4 sets the guidelines for the implementation of PAIs at entity level. Financial market participants, such as asset managers and other entities, are called upon to disclose the PAIs of their overall operations, how they take PAIs into consideration, and to explain, in case they do not consider them, the reasons for not doing so.

Financial market participants that declare that they take PAIs into consideration must report on PAIs annually, in a statement made available on their website. The first iteration of the PAI annual report taking into account the requirements of SFDR Level 2 is to be published by June 30th 2023. SFDR stipulates the structure and provides guidelines of the content of this report, which should provide:

- a summary;
- a description of the PAIs, including actions taken and planned, and targets set;
- a description of policies used to identify and prioritize PAIs;
- engagement policies;
- references to international standards; and
- for subsequent years, historical data showing the evolution of PAIs from one reporting period to the next.

PAIs at product level

The application of PAIs at product level is the subject of Article 7 of SFDR: financial market participants must give a clear explanation of whether and, if so how, financial products take PAIs into consideration. At product level, information regarding the integration of PAIs is meant to be communicated to the investor both prior to investment in a product, via the pre-contractual disclosures, and once a product has been invested, via periodic reports. The level of disclosures varies depending on the classification of the product according to SFDR – Article 9, 8 or 6.

The devil is in the detail... and in the data.

PAIs provide a useful framework for greater disclosure on the effects of investments on sustainability factors and make for greater harmonization and comparability of these disclosures. Nevertheless, it is important to keep in mind that the implementation of the PAIs, like many other aspects of sustainable investing, is subject to a data challenge.

In fact, while SFDR sets out metrics for each PAI, there is no specification of underlying methodologies or data sources to be used to compute these metrics. Moreover, while certain metrics are relatively straight-forward and quantitative in nature, others include aspects that leave room for different interpretations, approaches, and methodologies.

Importantly, this must be seen against the backdrop of the many challenges that still characterize ESG data. ESG data are not always disclosed by issuers nor easily accessible. Even when ESG data are available, their quality and materiality are often heterogeneous. Furthermore, with ESG still a field in development, the approaches and methodologies used to aggregate and interpret data and transpose them into indicators can vary greatly.

Take the example of PAI 7 – biodiversity, and more specifically activities negatively affecting biodiversity-sensitive areas. The metric for this indicator is the 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. The notion of “activities negatively affecting biodiversity-sensitive areas”, while absolutely critical from a sustainability perspective, is complex to assess. In fact, complete and accurate assessment requires both a spatial perspective and detailed asset-level data.

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The precise locations of each company's sites and plants must be known as well as the biodiversity context and ecosystems of these locations and how their multiple dimensions are impacted by the company's activities.

Standard sources of ESG data currently do not have such information. Therefore, alternative methodologies have come to the fore, for example approaches focused on identifying instances in which companies are involved in controversies in a limited number of biodiversity-protected areas. Such approaches, where impacts are only very rarely tied to a precise location, intrinsically offer an incomplete view. They do not reflect how companies impact biodiversity outside of the realm of these controversies, nor do they provide enough spatial detail to draw definite conclusions on the material impacts of economic activities on local ecosystems.

Does this mean that investors should not look at PAI-related disclosures when examining investment products or evaluating financial market participants? No, they can, and are well-advised to, look closely at PAIs. However, they should not stop there. In fact, it is key that they assess the underlying data, methodologies and resources used by the product provider to compute PAIs. Such due diligence will continue to be critical given the room left for interpretation in the principles-based regulation that is SFDR, and as long as ESG data vary in quality and materiality.

The ball is in the product providers' court.

In light of the aforementioned data challenges, financial product providers such as asset managers must offer investors transparency and clarity on the methodologies and resources they use with regards to PAIs. For instance, do they have dedicated in-house ESG experts that conduct in-depth analysis of ESG data, in order to evaluate completeness, quality and relevance for use in specific PAIs? Where data is not readily available or insufficiently material, do they invest in building their own fundamental approaches? Going back to PAI 7 – biodiversity, for example, are asset managers developing models integrating asset-level data and biodiversity-protected areas across the planet, in order to assess biodiversity in a truly meaningful fashion?

Investors' due diligence should also look at how PAIs are integrated into and addressed through different steps of the investment process, such as:

- Exclusions: How do PAIs influence the exclusions made from the ESG-eligible investment universe?
- ESG analysis: How do PAIs factor into the assessment of the sustainability of an issuer?
- Engagement and voting: How are dialogue with issuers and the exercise of voting rights used to take actions targeting specific PAIs?

For investors, asking such questions will provide essential context to understanding PAI-related disclosures. For asset managers, providing clear and in-depth answers will be key in demonstrating commitment to sustainable investing and truly meaningful implementation of SFDR.

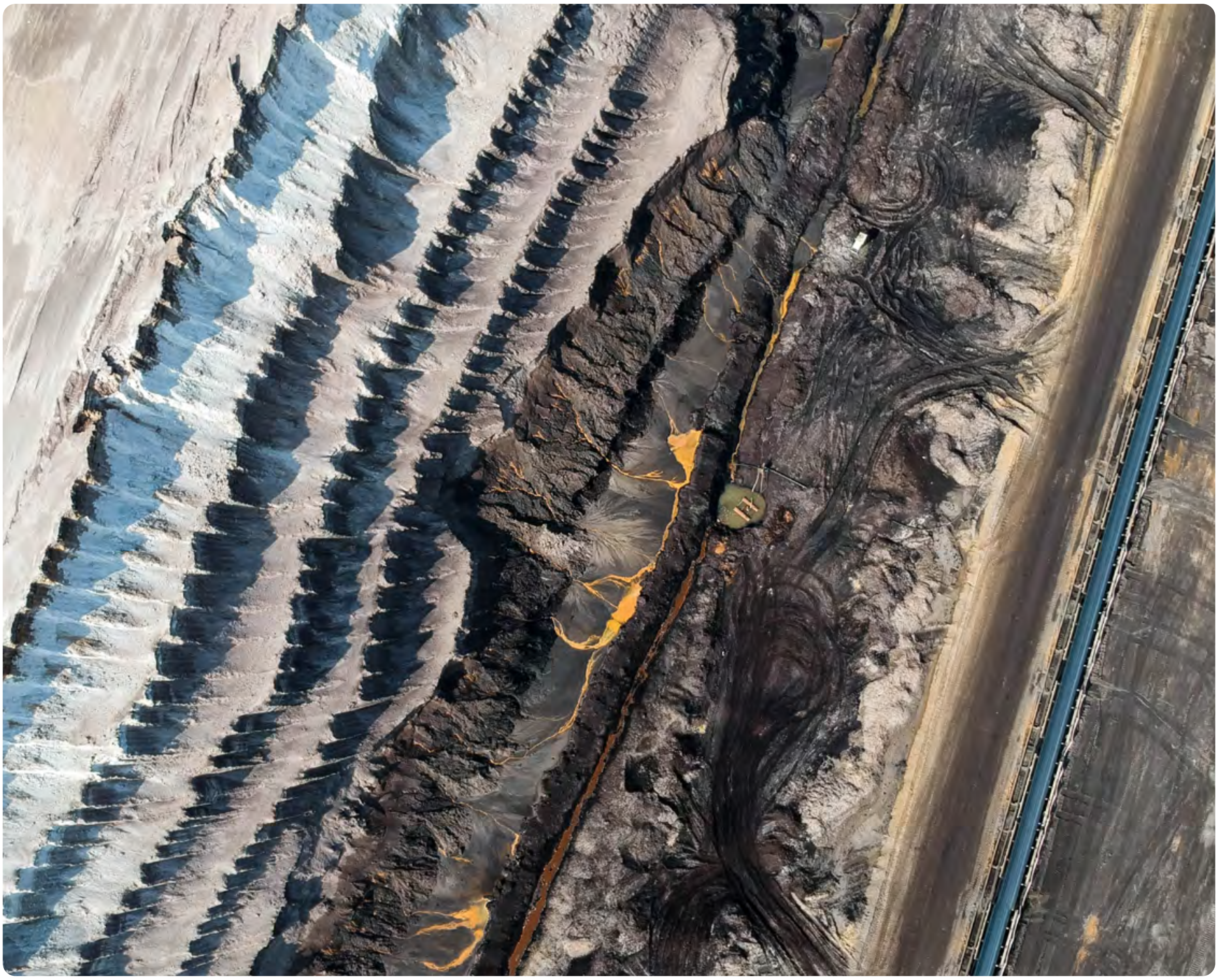
In conclusion.

Understanding, measuring, and mitigating the potential negative impacts of investments on the environment and society is nothing new. Experienced sustainable investors have long placed two elements at the core of their investment decisions: the sustainability risks that investments are subject to, and the effects that investments have on sustainability matters.

SFDR has provided a formal regulatory framework to this principle of double materiality, including a new standard for reporting on PAIs. For investors this new standard brings about not only a point of reference for comprehensive reporting, but also the opportunity to investigate product providers' approaches to data and ESG indicators. In fact, building an understanding of providers' approaches to PAIs is essential, not least to assess comparability of PAIs across products.

For asset managers, the PAI-related requirements are an opportunity to strengthen relationships with investors, based on the robustness and granularity of their methodologies, their resources dedicated to garnering quality, material ESG data, and their expertise in addressing and mitigating the PAIs of investments. Here, PAIs can also serve as a driver of increased ESG disclosures on behalf of issuers, which in turn will serve to further advance the field of sustainable investing.

It is important to keep in mind that SFDR is continuing to evolve. Following the implementation of Level 1 and Level 2, as well as additional guidance via Q&As, SFDR is likely to see further tweaks, if not revisions, in the future. As of Q2 2023 for example, a consultation by the European Supervisory Authorities is underway. Amongst the future amendments to SFDR under discussion are potential additions to the list of PAIs. Thus, PAIs are here to stay. Understanding them thoroughly and implementing them in a meaningful way will be important for sustainable investors going forward.



€139 B

AUM at end December 2022*

600

Experienced and committed professionals

+ 25 years

Leading the way in sustainable investing

*As of 31/12/2022, Candriam changed the Assets Under Management (AUM) calculation methodology, and AUM now includes certain assets, such as non-discretionary AUM, external fund selection, overlay services, including ESG screening services, [advisory consulting] services, white labeling services, and model portfolio delivery services that do not qualify as Regulatory Assets Under Management, as defined in the SEC's Form ADV. AUM is reported in USD. AUM not denominated in USD is converted at the spot rate as of 31/12/2022.

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