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NOTE

Definition of Sustainable Investment according to SFDR

AFG

AFG has been a federation of asset management professionals for 60 years, serving the needs of investors and the economy. It is the collective voice of its members, the portfolio management companies, whether entrepreneurial or subsidiaries of French or foreign banking or insurance groups. In France, the asset management industry comprises 700 asset management companies, with €4,800 billion in assets under management and 85,000 jobs, including 26,000 jobs in asset management companies.

AFG works for the asset management industry and its growth. It defines common positions, which it promotes and defends with public authorities, contributes to the emergence of solutions beneficial to all players in its ecosystem and is committed to promoting the industry's influence in France, Europe and beyond, in the interests of all. It invests for the future.

OVERVIEW

DEFINITION OF SUSTAINABLE INVESTMENT ACCORDING TO SFDR

CONTEXT

The *Sustainable Finance Disclosure Regulation* (SFDR), which entered into force on 10th March 2021, sets out rules for transparency of sustainability information for financial market participants and financial advisors. The level 2 measures apply from 1 January 2023 and require, among others, the disclosure of the "sustainable investment" proportion of financial products.

The definition of "sustainable investment", which is based on three pillars, is very general and can leaves room for significantly different approaches between asset management companies, which can generate confusion among investors.

As such, recital no. 17 of the Regulation provides: *"To ensure the coherent and consistent application of this Regulation, it is necessary to lay down a harmonised definition of 'sustainable investment' which provides that the investee companies follow good governance practices and the precautionary principle of 'do no significant harm' is ensured, so that neither the environmental nor the social objective is significantly harmed."*

This need for clarification was also reflected in the list of questions, notably on the definition of sustainable investment, sent by the ESAs to the European Commission on 9 September 2022[1]. AFG has carried out work to propose principles to clarify this definition.

DEFINITION OF "SUSTAINABLE INVESTMENT"

The definition in Article 2(17) of the SFDR Regulation forms the basis of AFG's work. A sustainable investment is an investment in an economic activity which:

– "contributes to an environmental or social objective";

– "provided that such investments do not cause significant harm to any of those objectives". ("*Do Not Significant Harm*" / "DNSH") ;

– "and that the investee companies follow good governance practices".

AFG's work clarifies these three pillars in order to increase the transparency of methodologies on key points and to limit their differences.

Contribution to an E or S objective

Recommendation 1: Considering an investee entity as "sustainable" entirely

AFG recommends to consider an investee company sustainable as a whole when it is identified as :

- "**Active**" (taxonomy alignment or contribution to the issues listed in the SFDR regulation, using a commonly accepted framework, such as the UN's SDGs)
- and/or "**committed**" (measurable and enforceable commitment, e.g. a company's commitment to transition measured by its current or projected investments and with monitoring and escalation processes monitored by the asset management company).

To encourage companies to transform, it is essential to consider the company as a whole to be sustainable as soon as it meets the selected criteria (see Recommendation 3) and not just the part of its activities that is aligned with the taxonomy, for example.

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[1] List of additional SFDR queries requiring the interpretation of Union law, ESAs, 9 September 2022.

Considering the company as a whole encourages the company to use all of its equity for its transformation, provided that there are tangible elements that prove the company's transition is engaged.

Focusing exclusively on certain activities or projects of companies would not be sufficient to cover their financing needs to transform themselves and would therefore be inefficient from a macroeconomic point of view. Indeed, it is important to remind that an asset management company that invests in a company, whether in equity or debt, is financing a company in its entirety and not just the part of its activities that is already sustainable.

This approach is essential for financing the transition and meeting the objectives of the European Green Deal. AFG's objective is to be able to finance as many European companies as possible and to support them in their transition.

Recommendation 2: Reference to a widely used common framework

In order to make it easier for investors to read, the AFG recommends that asset management companies be transparent in communicating their definition and method, notably threshold(s) above which a company is considered as sustainable entirely.

They can, notably, base themselves on a widely used common reference framework, such as the UN's Sustainable Development Goals (SDGs)[2].

Depending on the approach chosen by the asset management company, the SDGs can be used in different ways:

– Ex-ante : to define activities that contribute to a sustainable objective;
– Ex-post : for information purposes to demonstrate the contribution of investments to one or more sustainable objectives.

Recommendation 3: Criteria for meeting the definition of positive contribution

The criteria listed in this section are not cumulative criteria but options that asset management companies can use in their definition.

→ **Quantitative accounting elements: being able to integrate a forward-looking view of the issuer**

- **Turnover and alternatives :**

  The turnover is a widely used and recognised criterion for identifying the proportion of a company's activity that is already considered as sustainable (static vision). Limiting the contribution to this criterion alone does not allow for a forward-looking view of the company and therefore does not allow to consider it's the companies' transition (dynamics of change). It is then essential to allow asset management companies to consider other metrics to analyse the company. In other words, a company should be considered sustainable if it has a measurable and enforceable transition plan that are in line with the Paris Agreement.

[2] *17 Goals to Transform Our World: The Sustainable Development Goals are a call for action by all countries – poor, rich and middle-income – to promote prosperity while protecting the planet. They recognize that ending poverty must go hand-in-hand with strategies that build economic growth and address a range of social needs including education, health, social protection, and job opportunities, while tackling climate change and environmental protection. https://www.un.org/sustainabledevelopment/*

Furthermore, for some sectors (e.g. power generation), the turnover does not adequately reflect the company's ability to contribute to a sustainable objective. For example, in the case of power generation, installed power generation capacity expressed in MWh is more relevant.

- **Introducing the transition through CapEx and OpEx**

  To introduce the notion of a company's transition, AFG believes that it is useful to rely on companies' investment and operating expenses (CapEx and OpEx) for the calculation of the positive contribution.

  Widely used and recognised, they provide a forward-looking view of the company. It should be noted that the Taxonomy Regulation also allows these indicators to be used under certain conditions.

  The use of the CapEX and OpEX criteria is therefore useful to take into account the transformation of companies.

→ **Quantitative elements distinct from accounting elements: being able to consider the measurable and enforceable commitment of the company**

The AFG believes that other quantitative criteria distinct from accounting elements could and should be used by asset management companies when determining the positive contribution, provided that the sources and methodologies are transparent.

Beyond the accounting criteria, we consider that companies already offering or using solutions to address environmental or social issues should be considered as "sustainable investments" even when these activities are not already reflected by a high proportion of turnover contributing to a sustainable objective. Notably, a company's measurable and enforceable commitment to the development of E- or S-oriented activities should be taken into account in the assessment of the sustainability of activities by asset management companies.

With regard to climate transition, there are currently several initiatives aimed at analysing/certifying companies' transition plans, such as SBT. These initiatives can serve as a basis for analysis by asset management companies, provided they are transparent and robust. With the implementation of the CSRD, companies will have to communicate more widely on their climate and biodiversity transition plans. This will allow asset management companies to assess the quality of these plans and to qualify a company in transition as a sustainable investment.

Moreover, the AFG recognises the role that asset management companies' dialogue with companies plays an essential role to encourage them to adopt transition plans in line with the Paris Agreement. This dialogue also allows for the monitoring of a company's progress in its transition with precise objectives. It must be framed by an engagement policy that describes the planned escalation measures (company under alert, downgrading, etc.). A company should not be considered as "*sustainable*" if the company is not deemed capable of achieving its transition plan.

These quantitative elements, distinct from the accounting elements, are particularly relevant to consider for activities contributing to a S objective.

The definition of sustainable investment is based on the contribution to an environmental (E) or social (S) objective. While there are several frameworks for defining a contribution to the E-pillar, there is not yet a recognised European framework for defining a contribution to the S-pillar.

The transition of companies must not be at the expense of the social question. It is therefore essential to take these issues into consideration to work towards a just transition.

Asset management companies should continue to be able to select companies based on one or more relevant social indicators reflecting a sustainable activity contributing to a S objective. The asset management company should communicate the indicator(s) used as well as the methodology used to select the company (eligibility level).

Again, the availability and robustness of information will be improved with the entry into force of the CSRD.

To summarise, AFG recommends that the following elements be considered when defining a company's contribution to an environmental or social objective:

- The turnover percentage contributing to an environmental or social objective or any other relevant indicator of the company's contribution to an E/S objective;
- The share of projected CapEx and/or OpEx contributing to an environmental or social objective or;
- Quantitative elements distinct from accounting elements, including :
    - Consideration of business solutions that contribute to an E/S objective;
    - Measurable and enforceable company transition plans in line with the Paris Agreement;
    - Any other element allowing the assessment of the company's contribution to an S objective, provided that the indicators and the assessment methodology are specified by the asset management company.

"Do not significant harm"

Principal Adverse Impact

In June 2022, the European Supervisory Authorities (ESAs) clarified[3] that the use of PAIs should be retained to demonstrate the DNSH of sustainable investment. The ESAs did not specify the approach to be followed for the "consideration" of PAIs.

AFG believes that the consideration of the 14 mandatory PAI[4], as provided by the SFDR Delegated Regulation, will allow a certain level of harmonisation between asset management companies.

It should be noted that in the current state of the Sustainable Finance framework (CSRD, SFDR, Taxonomy), asset management companies are making their best efforts to consider all mandatory PAIs. In the absence of data from issuers (CSRD data will be available from 2025 onwards) or when indicator coverage is low, asset management companies may use other analysis (quantitative via scoring, qualitative via enhanced controversy assessment, etc.) to meet their regulatory requirement.

[3] Clarifications on the ESAs' draft RTS under SFDR, ESAs, 2 June 2022

[4] The 14 PAI are used by the AFG for harmonisation purpose. However, it is important to remind that asset management companies are required to take into consideration the PAIs of table 1 of Annex 1 (i.e. the mandatory PAIs) as well as any relevant indicator of tables 2 and 3 of this Annex.

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Exclusions

To meet their regulatory requirement with regard to the DNSH, asset management companies also use normative and sectoral exclusions. Since each asset management company has its own exclusion policies, the AFG recommends transparency by publishing these policies. AFG has also published guides on the subject (Guide to developing a coal strategy and Guide to developing a fossil fuel strategy).

Controverses

To meet their regulatory requirement with regard to the DNSH, asset management companies monitor companies' controversies. A company can only be considered as contributing to a sustainable objective if it complies with the controversy policy established by the asset management company.

AFG recommends transparency by publishing these policies.

Principles of good governance

The SFDR regulation specifies the definition of the principles of good governance to be taken into consideration by asset management companies by referring to the following 4 pillars: "sound management structure", "employee relations", " remuneration of staff" and "tax compliance".

AFG recommends that asset management companies refer to these 4 pillars. Pending the availability of standardised data on these pillars (CSRD), asset management companies may refer to a G-indicator that covers other aspects as long as these four elements are represented.

MARKET REFERENCE

The principles resulting from AFG's work will make it possible to harmonise the practices of asset management companies with regard to the definition of a sustainable investment within the meaning of the SFDR regulation. Given the different approaches and methods used by asset management companies, it would be difficult and inefficient to set harmonised threshold levels for each of the criteria.

The AFG launched surveys asking members to estimate, based on their own *sustainable investment* definition before the publication of these high level principles, the share of *sustainable investment* of widely used market indices. The February 2023 survey, covers 70% of French assets under management, allows to estimate the share of sustainable companies resulting from the current methodologies of each asset management companies in three indices (see table below).

The AFG will conduct this survey on a recurring basis to evidence market evolution.

	Average	Median	Standard deviation
MSCI Euro	48%	44%	23%
MSCI Word	42%	40%	19%
Iboxx Euro Corporate	38%	35%	17%

AFG

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pour demain

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