INFRASTRUCTURE

Regulation: What SFDR means for infrastructure funds

BY RENÉ LAVANCHY | JANUARY / FEBRUARY 2021 (MAGAZINE)

Infrastructure funds that market themselves as sustainable to EU investors will come under new rules from March. René Lavanchy reports

On 10 March, the EU's Sustainable Finance Disclosure Regulation (SFDR) will come into force. It will usher in a set of requirements to make disclosures and create policies about sustainable finance which will apply – at least minimally – to all asset managers marketing themselves to investors in the EU. Some commentators expect it to set an example which the rest of the world will follow.

Such an example cannot come soon enough, suggests Nishtha Manocha of the EDHEC Infrastructure Institute. Last year, EDHECInfra studied 17 different ESG evaluation schemes relevant to infrastructure investment. "One of the conclusions that came out of it was that they are very divergent and hence there is a need for consolidation. This is where I feel Europe is moving ahead in the race," she says. "As long as this is voluntary, and there are 20 different schemes existing which are different, you can't come up with a final answer and you can't compare."

The intent behind SFDR and its sister regulation, the EU taxonomy, is to harmonise how asset managers and financial advisers assess ESG-related risks and impacts, and to prevent greenwashing by imposing particularly detailed responsibilities on funds that are marketed as sustainable. But the regulation is not quite as ambitious as it at first appears.

For one thing, 10 March will be something of a soft launch. The date is the earliest that asset managers can begin to comply with the most basic requirement on so-called Principal adverse impacts of their investment decisions on 'sustainability factors', and compliance mainly means publishing a statement on their website explaining the due diligence policies in place to deal with those impacts, and any action taken over them. Firms with at least 500 employees will need to comply with that requirement by the end of June. For smaller firms, it is optional, on a comply-or-explain basis.

"We think that is mostly information that all participants will pretty much have readily available, or can prepare pretty readily and put on their websites.… it's fairly high-level information," says Rick Walters, director of infrastructure at ESG benchmarking provider GRESB.

One year after whenever firms begin publishing this information, they will need to disclose principal adverse impacts with more details about the precise sustainability factors being assessed – so-called Level 2 information. Originally, these factors consisted of 50 separate indicators and metrics, including carbon emissions, carbon footprint, deforestation and more. Of the 50 indicators, 32 were mandatory.

However, when this list was published in April 2020, there was said to be strong opposition from the industry to the perceived difficulty of the reporting requirements, and the European supervisory authorities shelved the list. Pending a new list, firms can use their judgment.

"For the interim period, while we have no Level 2 measures and so firms take a 'principles based' approach to compliance, the market trend is not to choose to apply 32 plus 18 very detailed fields; instead, there is a general trend in the industry to do a much smaller number of fields – six to eight different sustainability indicators," says Lucian Firth, partner at law firm Simmons & Simmons.

As well as being a lighter load for now, it has recently emerged that because of Brexit, UK firms will escape SFDR altogether, unless they are marketing to EU investors (and even then, the principal adverse impacts regime will not apply). "There's a plus and a minus to this," Firth says, "because clearly, for some funds, actually being in scope of SFDR is a good thing and they see advantages in being able to market themselves as being in scope.… and for some, that's not the case." He adds that he expects some British firms to comply voluntarily.

"For us, not much changes… We did the heavy lifting in the last two years"
BARBARA WEBER

But how much difference will SFDR make to greenwashing? This is where product-level disclosures for specific funds come in. There are some basic requirements for all funds with regard to how sustainability risks and their impacts are considered in investment decisions, but this does not stop a fund from investing in any type of asset. Extra requirements under Articles 8 and 9 of the regulation apply to funds that either promote environmental or social characteristics, or have a sustainable investment objective (including aiming to reduce carbon emissions). These funds will need to demonstrate how their sustainability goals are being met.

For one thing, some of these obligations are pre-contractual, which means they are not expected to be applied by funds that have reached final close. In theory, funds that market themselves as sustainable and which are still fundraising would have to apply the regulation to continue doing so. In practice, there are unlikely to be many infrastructure funds in that position.

"Those funds that are already on the road probably aren't describing themselves expressly as 'sustainable', unless they've already thought about it and can continue to do so," argues David Williams, partner at Simmons & Simmons. And there are not many of those.

"It's unlikely that SFDR will prove to be a leveller straight away, because there are so few true Article 8 or Article 9 financial products out there in real assets," says Ed Dixon, head of ESG for real assets at Aviva Investors.

Nevertheless, Dixon is optimistic that the regulations will have an impact: "SFDR and the EU taxonomy, working in tandem with benchmarks, should begin to delineate between which financial products are truly sustainable and which are not. My hope is this will prevent infrastructure funds claiming to be sustainable financial products because they perform very well against the benchmark, despite investing in activities which are clearly unsustainable."

One firm that will be affected is B Capital Partners, a Swiss-based asset manager that invests in what it views as "core sustainable infrastructure", including hydro and wind power. "We have explicitly positioned the entire firm on sustainability, so we are falling under Article 8 and 9," Barbara Weber, the firm's founding partner, says.

"For us, not much changes.… We did the heavy lifting in the last two years," she adds, noting that the company has planned ahead. B Capital also released last year an open-source ESG due-diligence tool for screening infrastructure assets, which could be used for meeting the SFDR's adverse impact requirements.

The main challenge may well lie in the EU taxonomy, which aims to determine whether a business is carrying out environmentally sustainable activities or not. This is done in respect of six sets of environmental objectives, each of which will have lists of "technical screening criteria" – quantifiable performance thresholds such as for greenhouse gas emissions reduction. The taxonomy is not expected to come into force until January 2022, and only applies to funds with an express environmental sustainability goal. GRESB has already started offering its clients the chance to check if their assets are taxonomy-compliant.

Most of those criteria have not yet been published, however, and so far there is no official methodology for measuring them. "The actual assessment and quantification of ESG risks and impact – that is the hard part," Weber notes, adding that B Capital is involved in some initiatives in that field.

"SFDR and the EU taxonomy, working in tandem with benchmarks, should begin to delineate between which financial products are truly sustainable and which are not. My hope is this will prevent infrastructure funds claiming to be sustainable financial products because they perform very well against the benchmark, despite investing in activities which are clearly unsustainable" Ed dixon

Then there is the rule of doing "no significant harm" to the objectives, which a fund must meet to be labelled sustainable. GRESB's Walters notes that the industry is still waiting for guidance on how this will be demonstrated. "We think they're going to come to a fairly sensible conclusion about just showing you have processes to make sure that you are not causing that harm, and then… the results of those processes." More detailed requirements, such as itemising every single type of harm, would be "quite onerous", he argues.

Dixon notes that Aviva Investors' infrastructure equity fund is not marketed as an impact fund, and therefore not covered by the most stringent disclosure rules of SFDR or the taxonomy. Nevertheless, he says, Aviva aims to increase the proportion of fund activities aligned to the taxonomy.

He does not say whether Aviva plans to launch an EU-compliant sustainable fund, but insists that the new regulations represent an "enormous commercial opportunity". He says: "If you look at the inflows of capital into sustainable funds on the liquid side, they are racing ahead of conventional strategies and year-on-year growth has been huge."

Williams at Simmons & Simmons is cautious about reading across from liquid markets. He argues that whether it is valuable for funds to have explicit environmental or ESG badging will depend on whether investors demand it, or whether they prefer to use their own, diverse ESG requirements and standards to assess funds – although he does think the standards have a good chance of being used as positive badging by managers.

Manocha, however, argues that all standards go through phases of diversification followed by consolidation. "Eventually these schemes either consolidate.… or they're brought into regulation by the regulators, as you see with the EU taxonomy," she says. "I think the EU taxonomy's a great example of the path this whole universe will take."

EUROPE INFRASTRUCTURE REGULATION SUSTAINABILITY

Most popular | Latest

TPG Real Estate launches UK industrial investment platform
1

Aviva Investors adds £139m distribution centre to UK portfolio

Should infrastructure investors write-down their airport investments?

Cordiant Digital Infrastructure raises £370m in London IPO

Savills IM buys Polish logistics asset for Korean investors

RELATED ARTICLES

NEWS
Fundraise for second Bain Capital Real Estate fund reaches $1.1bn
17 FEBRUARY 2021
Bain Capital Real Estate Fund II seeks to raise $1.6bn capital

NEWS
Bouwinvest commits €100m to NREP Nordic real estate strategy
17 FEBRUARY 2021
The NREP strategy targets assets like affordable rental housing, care homes and logistics

NEWS
Principal Real Estate long-income fund invests in Irish social housing
17 FEBRUARY 2021
Principal Eurozone Durable Income Fund buys Dublin portfolio for €20m

LOAD MORE ARTICLES

NO COMMENTS YET

You're not signed in.
Only registered users can comment on this article.
SIGN IN REGISTER

MORE INFRASTRUCTURE

NEWS
Should infrastructure investors write-down their airport investments?
12 FEBRUARY 2021
It is unavoidable that the risk premia used to discount the future cash flows has increased

MAGAZINE
David Faulkner: 10 principles for making cities climate-resilient
JANUARY / FEBRUARY 2021 (MAGAZINE)
The Urban Land Institute and Centre for Liveable Cities have formulated 10 principles for making cities climate-resilient. David Faulkner explains

MAGAZINE
A new ESG benchmark for listed infrastructure companies
JANUARY / FEBRUARY 2021 (MAGAZINE)
A new index launched in collaboration with GLIO will begin shining light on the ESG performance of listed infrastructure companies. Fraser Hughes and David Tassadogh explain

LOAD MORE ARTICLES