EXPERT Q&A

Transparency is improving as new regulatory initiatives take hold, but fund managers still need to work hard to get a better understanding of what their investors need, say Arendt's Stéphane Badey, Nicolas Bouveret and Antoine Peter

Promoting transparency in ESG

Q Given the current regulatory backdrop, how crucial is ESG transparency in the private debt market these days?

Stéphane Badey: It is definitely becoming more and more important for our clients. When the European Commission launched its sustainability finance action plan in 2018, it put the transparency exercise ahead of anything else. Private funds have to be extremely clear about what they do regarding ESG and show that they are being transparent towards investors.

This has resulted in funds being split into different categories. Asset managers are now routinely asked: what is your categorisation under the EU's Sustainable Finance Disclosure Regulation (SFDR)? This has put pressure on many funds to work towards becoming either an Article 8 or an Article 9 fund, which has caused them to reach for an ever-greater level of transparency and ambition to demonstrate their ESG credentials and justify the category to which they claim to belong.

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Q How can funds best demonstrate that they are ESG-compliant?

Antoine Peter: We get asked this question a lot, but it is difficult to answer because for Article 8 funds, for example, there aren't any minimum ESG requirements (yet).

The EU framework is not to be seen as a labelling regime but rather a transparency regime. If you have given the impression, either directly or indirectly, that your fund is an ESG fund, then you will fall under the scope of Article 8 or Article 9 of the SFDR regulation and must make the necessary disclosures.

The European Commission has deliberately left things very open because it is trying to catch as many fund managers as possible to be more transparent in their disclosures. Regulators maintain that it is not their job to judge the credibility or the materiality of what is on offer, but rather to make sure that investors understand the products that they are being sold. For them, this is a consumer protection issue.

But this is also where some confusion creeps in. Since there is no minimum threshold, it is up to the market to set the limits, and to determine what funds should or should not do. Where is the bar set? Where is the threshold? Where do the limits lie? It is then up to the investors, to the NGOs, to the journalists to decide whether what is on offer is credible. This is definitely the part that most people are struggling with at the moment.

Nicolas Bouveret: I have noticed there are two different approaches being used at the moment. One is the check-box approach that many private debt funds investors use to determine which category of funds they can invest in. For these players, regulatory classification is really important.

The other approach is to rely on their in-house due diligence, with institutional investors imposing their own criteria on the ESG mandates that they are prepared to give. This approach tends to be more popular with larger institutions, particularly those making substantial commitments or using SMA [separately managed account] structures.

Q Are investors being given enough information to properly evaluate funds?

SB: This is where transparency becomes key because investors have embraced the topic for which they have developed expertise. When subscribing to a financial product, investors are presented with a lot of information. Much of this is rather technical and not easy to understand. It is in a way far easier for investors to question a portfolio of investments linked to the oil and gas sector than, for example, to criticise the technical computation of carried interest.

Investors can quickly lose trust if the underlying portfolio of a fund promoting itself as ESG-friendly is very similar or identical to that of another fund without such ESG credentials. This becomes a particular danger when markets are facing downward pressure. Investors may claim that they were wrongly informed and that the fund has been less resilient because it has been investing in the wrong things.

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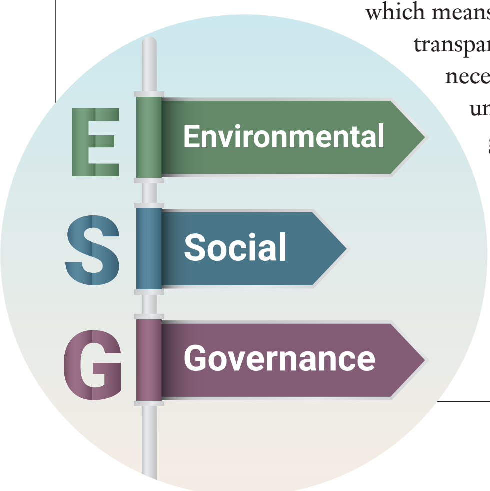
>
> **ANTOINE PETER**

Q Is there a sufficient level of transparency in the market?

SB: Transparency has definitely been improving – and it has got to. After all, the deadline for the implementation of SFDR is the end of this year. People are now really starting to understand the difference between financial materiality and looking at this from a risk management point of view. In other words, is the company doing this for profitability or because it wants to sell the latest ESG fund?

This is an important distinction that companies need to make. We have seen a number of cases where disclosures fail to adequately address this, which means that, while the spirit of transparency might be there, it doesn't necessarily provide a particularly good understanding of what is actually going on.

Of course, improvements can always be made: better financial literacy and availability of data from the underlying companies into which funds invest would help, for example.



AP: Transparency can be a bit of a double-edged sword, though. On the one hand, many asset managers want to inject more transparency into their fund offering documents to protect themselves against misselling claims and make sure they are meeting the expectations of their investors. Everyone has a different definition of what 'sustainable' is, and so greater transparency helps fund managers avoid some of this confusion.

But, on the other hand, increasing transparency also risks exposing fund managers to greater levels of scrutiny and criticism by allowing investors to gain a better insight into what is actually going on. This is not just about what NGOs and journalists might think. It is also about how investors see things.

Q So too much transparency might not necessarily be a good thing?

NB: It's not really a question of whether there is too much transparency or not. It's more a question of what transparency means to different people. This comes down to fund managers really knowing who their investors are, and what they would like to see in terms of disclosures. SFDR doesn't make this distinction, but this is something that needs to be reflected in the markets.

Conversations with institutional investors usually revolve around a dialogue between the asset manager and the ESG team. It's a very different story, though, if asset managers are trying to sell funds to private bank clients or to a broader retail network. Education has an important role to play here, too. The ESG dialogue will obviously be very different for an illiquid loan origination fund compared with a more liquid strategy, but the individual investor might not fully understand that. There is a big push within the private debt space to move beyond traditional institutional investors – and so this has become a very important part of the transparency exercise.

Q What role do ESG-linked financings play in improving the overall level of transparency in the market?

AP: It has become more-or-less standard practice these days for private debt funds to have some sort of sustainability-linked financing, with additional marginal financial benefits linked to meeting certain KPIs. In fact, so standard is this practice now that we regularly see sustainability-linked financing referenced in investment strategy presentations without it even being perceived as a promotion of ESG.

In this way, an Article 6 fund, for example, may claim that it doesn't want to be anything higher, but in reality, it has already introduced some ESG criteria into its financing agreements in order to foster more transparency at borrower level, for example, which in turn is perceived to reduce downside risk. The idea in this set up is to give a small incentive to portfolio companies and borrowers to gather and disclose some non-financial information and to undertake some preliminary ESG-related actions that are perceived as good risk management.

"Transparency has definitely been improving – and it has got to"

STÉPHANE BADEY

"It's more a question of what transparency means to different people"

NICOLAS BOUVERET

This shows how ubiquitous sustainability-linked financing has become, but it also highlights a potential challenge: how can industry practices be reconciled with the SFDR categorisations?

This is where fund managers have to be careful. When it comes to things like setting up reporting standards and establishing mechanisms for sustainability-linked bonds, the industry is actually ahead of the regulations, but fund managers need to be aware of any regulatory spillover from the actions that they are taking.

ESG-linked financing definitely helps in terms of increasing transparency. If you look at a lot of sustainability-linked KPIs, you'll find the main goal is to make sure the underlying company is transparent. So just the fact that fund managers can start gathering data and thinking seriously about how to measure their non-financial KPIs is an important step towards a more transparent world. This is something that private debt investors will reward.

Q To what extent can third party data providers help with any of this?

SB: To be honest, I'm not sure if data providers are particularly relevant in the private debt market. As soon as you start dealing with mid-market non-listed companies, data sourcing is going to be pretty much directly from the investee company itself – and that means educating the investee companies about the disclosures that they should be making.

This is a different story when it comes to public debt, but even here the value that data providers bring depends on the quality of their methodology and the data that they can source. This is why asset managers often rely on more than one data provider: the ESG score for each firm tends to vary widely according to the methodology being used and who is doing the rating. ■

Stéphane Badey and Nicolas Bouveret are both partners at Arendt; Antoine Peter is a manager specialising in ESG and sustainable finance solutions