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Mastering Sustainable Investments:

A complete guide to create your methodology

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Introduction

As an asset manager or wealth advisor, you likely have pondered the question of sustainable investments once or twice. After all, the concept of sustainable investments is mentioned in the SFDR texts and in the sustainability preferences under MiFID II. Turns out, it is one of the greatest pending question marks regarding both these sustainable finance regulations.

SFDR gives a conceptual framework, but it is up to the teams responsible for each financial product to create a full methodology to assess their sustainable investments. This is far from a straightforward process.

That is why our team at Datia put together this step-by-step guide to help you navigate this process. If you have further questions, reach out to our experts at hello@datia.app.

Who can benefit from this guide

This guide was tailored to institutions marketing financial products under SFDR's Article 8 and Article 9 guidelines - commonly called "light green" and "dark green" financial products.

These products are either promoting environmental or social characteristics ("Article 8") or they have sustainable investment as their objective ("Article 9") and, therefore, need to disclose what percentage of the portfolio is considered a sustainable investment.

If you are planning to launch an "Article 8" or "Article 9" financial product or to upgrade your existing mainstream product ("Article 6"), this guide will certainly help you plan the work.

Content table:

Glossary:

Article 6: Products not promoting environmental or social characteristics nor targeting sustainable investments, but potentially integrating sustainability risks into the investment process ("mainstream")

Article 8: Products that promote environmental or social characteristics ("light green")

Article 9: Products that have sustainable investment as their objective ("dark green")

EBA: European Banking Authority

EIOPA: European Insurance and Occupational Pensions Authority

ESAs: European Supervisory Authorities (EBA, EIOPA and ESMA)

FMPs: Financial Market Participants

PAI: Principal Adverse Impacts

SDG: Sustainable Development Goals

SDFR: Sustainable Finance Disclosure Regulation

SI: Sustainable Investments

What are Sustainable Investments according to SFDR

The term "sustainable investments" is used in different contexts - sometimes in a generic sense, or maybe also referring specifically to definitions such as the EU Taxonomy for sustainable activities.

The Sustainable Finance Disclosure Regulation (SFDR) defines the term "sustainable investments" in the context of financial products and services in the following terms:

> *"'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water, and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration, and labor relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."* – SFDR, article 2

If we try to extract the main concepts in this paragraph we then reach the conclusion that, for SFDR, sustainable investments are those that contribute to an environmental objective or to a social objective, while not significantly harming any other objectives. At the same time, the underlying assets must be companies with established good governance practices.

Note that, if an investor defines a methodology with indicators for positive contribution and demonstrates how it does not do significant harm but does not define a set of criteria for "good governance", then absolutely no proportion of the financial product's portfolio can be considered sustainable.

To summarize, SFDR's requirements are:

Sustainable

- ✓ Positive contribution
- ✓ DNSH
- ✓ Good governance

Not sustainable

- ✓ Positive contribution
- ✓ DNSH
- ✗ Good governance

SFDR's guidance for creating a Sustainable Investments methodology

SFDR's paragraph explaining its concept of "sustainable investments" is notably very dense, with precisions about the level of consideration for the calculations, as well as examples of metrics that can be used in the assessment.

In the table below, we will distill the details explained in the paragraph, and include more examples of data to be used for the KPIs.

	Level of consideration	Examples	Data to be used
Positive Contribution to Environmental or Social objective	Economic activities (e.g. revenue streams or capital expenditures)	**Environmental objectives (indicated by SFDR)** • Efficiency indicators on the use of energy, renewable energy, raw materials, water, and land • Production of waste, and greenhouse gas emissions **Social objectives (indicated by SFDR)** • Impact on biodiversity and the circular economy • Contribution to tackling inequality • Fosters social cohesion, social integration, and labor relations • Investment in human capital or economically or socially disadvantaged communities	**Indicated by SFDR:** • Green or social revenue streams **Other possibilities:** • SDGs contributions • Green or social capital/ operational expenditures • Other types of operations contributing to an environmental or social objective
Do Not Significant Harm (DNSH)	Investment	• Carbon footprint, GHG intensity • Activities negatively affecting biodiversity-sensitive areas • Violations of the UNGC or OECD principles • Gender pay gap	**Mandatory according to SFDR:** • PAI indicators (the ones considered relevant to the methodology) **Other possibilities:** • Business involvements
Good Governance	Company	**As indicated by SFDR:** • Sound management structures • Employee relations • Remuneration of staff • Tax compliance	**Indicated by SFDR:** • PAI indicators • Business controversies • Sanctioned nations

Tip: Read the clarification about the use of the PAI indicators in sustainable investment methodologies published by the ESAs

The challenges with disclosing your sustainable investments

Regardless of how much one tries to distill SFDR's guidelines for sustainable investments, the entire definition written in the regulation is still very vague. No wonder FMPs might find it scary to come up with an entire definition for their financial products. We grouped some of the most frequently asked questions that our team comes across in three different themes:

THEME: SFDR's CONCEPTS

Questions: How to assess **harm?** What is **significant?** What constitutes a **contribution?**

Datia's team suggestion:
Imagine a scenario in which you notice that the Principal Adverse Impact indicators of a specific company are not great. But should you consider them acceptable, harmful, or significantly harmful? In other words, what exactly should be a limit to consider that the company is indeed doing significant harm? The answer to this question is: your team needs to find a threshold that seems reasonable to you. The same applies to your assessment of positive contribution.

THEME: DEFINING THRESHOLDS

Questions: What is a **reasonable threshold?**

Datia's team suggestion:
Selecting reasonable thresholds is a challenge in itself. Investors want to find metrics that do a good job of defining the concepts of "significant harm" and "positive contribution". At the same time, the thresholds need to work in harmony with your investment's strategy. Our suggestion is that you test several thresholds and learn what impact it has on your proportion of sustainable investments and on the sustainable investments classification of each of your investee companies.

THEME: BROWN SECTORS

Questions: Accounting for "**brown sectors**"?

Datia's team suggestion:
Now imagine a scenario in which a company operates in a "brown sector", but the same company has other operations that could be considered "green". For example, a conventional "oil and gas" company could be involved in hydrogen or renewables as well as fossil fuels. Can this company be considered a sustainable investment given that it meets other criteria set in your sustainable investments methodology?
In these cases, it is up to the investor to decide how to classify the company. However, there are a couple of important aspects to consider:

- Can the company still qualify for DNSH screening?
- Is the investment aligned with the overall investment strategy, including exclusions?
- Does the company have a credible transition plan in place?
- In cases like this, with a high degree of complexity, how transparent are the disclosures explaining to users how the sustainable investment classification is done?

Tip: Read the 2022 analysis of funds with sustainable investment as its objective conducted by the Swedish Financial Supervisory Authority (Finansinspektionen)

Steps to create a methodology for Sustainable Investments

If creating a methodology was a project, we would recommend the following process:

STEP 1
Select KPIs

- Select the Key Performance Indicators (KPIs) that will work, in combination, to demonstrate how your financial product does the following:
    a. Has a positive impact on the environment or on social aspects
    b. Does not significantly harm (DNSH) the environment or/and society
    c. Invests in institutions with good governance

STEP 2
Apply thresholds

- To each of the KPIs selected, apply numerical thresholds such as an absolute value to be achieved or a percentage above or below the values reported by your benchmark. Note that the use of PAI indicators is mandatory to assess DNSH.

STEP 3
Dry run

- Your KPIs and thresholds are the building blocks of your methodology. Screen your portfolio in light of this newly created methodology to verify what percentage of sustainable investments is reasonable to commit to in the pre-contractual of your financial products. *After all, the information in the pre-contractual is legally binding.*

STEP 4
Report

- Once you completed the hard work of creating a methodology to classify sustainable investments, it is time to enjoy the fruits of your hard work. Sustainable investments apply to two SFDR templates: the pre-contractual and the periodic report. In the pre-contractual, you set out the **minimum** planned percentage of sustainable investments, whereas in the periodic reporting, you are supposed to disclose **the actual outcome**. In addition to including the planned and actual percentage of sustainable investments, you also need to include background information on the methodology. For example, you will need to describe how and to which environmental or social objective the product is contributing, as well as how the DNSH aspect is ensured.

Note: After screening your portfolio against your methodology, you might reach a lower-than-expected proportion of sustainable investments. If that is the case, your financial product might not be ready to commit to a big percentage of sustainable investments just yet and your team might want to take this as a sign that it might be time to divest from bad-performing instruments and invest in more sustainable companies instead. Therefore, you should interpret the sustainable investment screening process as a test of the sustainability health of your financial products.

How investors are using data for screening so far

By now, you can probably tell that your team needs to set rigid processes regarding the use of data in order to assess your sustainable investments. You need, for example, to evaluate PAI indicators and identify revenue streams. To give you inspiration, we listed some ways that investors are using data in their assessment of sustainable investments:

Exclusion & inclusion

We noticed that, as a baseline, investors set exclusion criteria, stating, for example, in which sectors they do not invest.

Revenue streams for positive contribution

Investors need to dig into the revenue structure of their investee company in order to identify what activities could be considered positive and what revenue is associated with those.

Comparison to benchmarks

Benchmarks can be very useful, for example, in assessing significant harm. You can compare the PAIs of an investee company to a specific industry the company belongs to or a region where the company is located.

A caveat: the disclosure of the use of benchmarks is a requirement for financial products following Article 9 guidelines.

Be conservative with estimated data

We noticed that the industry is generally cautious when it comes to assessing their proportion of sustainable investments based on estimates. If they do use estimates, they might want to apply additional research to understand the context of the company at hand.

Adjust to intensity measures

A best practice is to adjust metrics such as carbon footprint and greenhouse gas (GHG) intensity to the size of the company, after all the emissions of a company with 10 production sites differ dramatically from the emissions of a company with one production site.

Examples of KPIs and thresholds for a methodology

Here are some practical examples of how you could select KPIs and thresholds for your methodology. By no means, Datia's team recommends that the examples below be used as your methodologies. Instead, this is our attempt to make the explanations shared in this guide as clear and tangible as possible.

Example 1: The green portfolio

	KPIs	Thresholds
Positive Contribution to Environmental or Social objective	Green revenue streams	The company has **at least one** green revenue stream
Do Not Significant Harm (DNSH)	Carbon footprint	The company is within the **80% companies with the lowest value** in industry benchmark
Good Governance	Legal proceedings	Company has not been involved in severe controversies

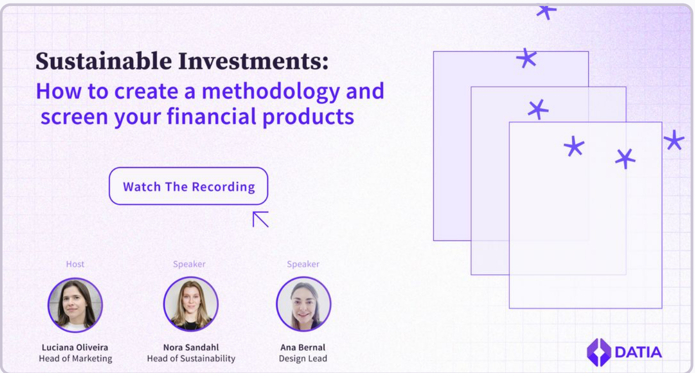
Example 2: The sustainable-development portfolio

	KPIs	Thresholds
Positive Contribution to Environmental or Social objective	SDG alignment	The company is contributing to **at least one** SDG
Do Not Significant Harm (DNSH)	Violations of UN Global Compact or OECD principles	The company has **not** been involved in violations
Good Governance	Fair remuneration	The company is paying **fair wages** to its employees

Example 3: The social portfolio

	KPIs	Thresholds
Positive Contribution to Environmental or Social objective	Social revenue stream	The company has **at least one** social revenue stream
Do Not Significant Harm (DNSH)	Non-renewable energy consumption	The company's share of non-renewable energy consumption is **less than 75%**
Good Governance	Tax compliance	The company has **not** been involved in controversies related to tax compliance or evasion

More resources about Sustainable Investments

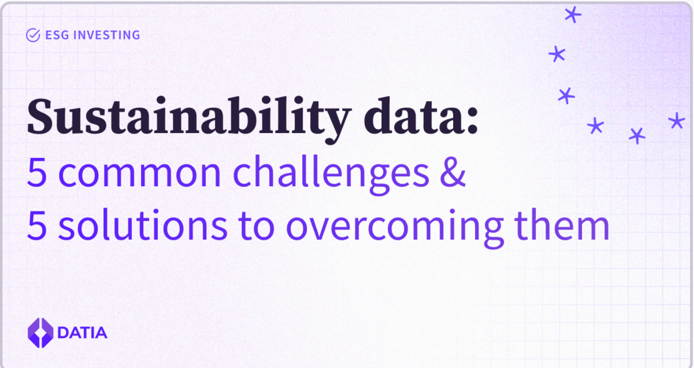


Sustainable Investments: How to create a methodology and screen your financial products

[Watch the recorded webinar](#)

The state of sustainability data in 2023: Overcoming quality and complexity challenges

[Watch the recorded webinar](#)



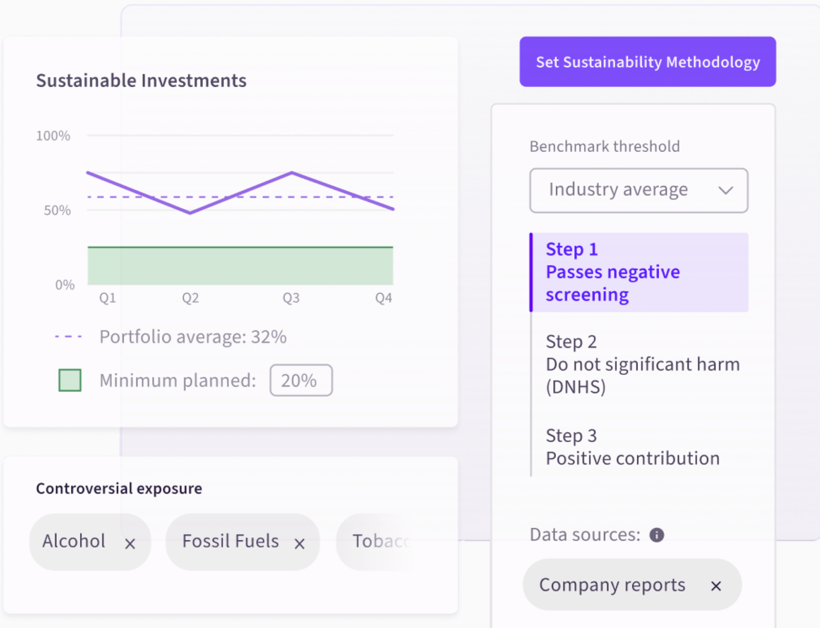
Our list of 5 technical solutions that will improve your work with sustainability data

[Read the article](#)

How Datia can help you with Sustainable Investments

Datia enables FMPs to quickly assess what percentage of their portfolio are sustainable investments according to their own methodology while relying on transparent data. Here's how:

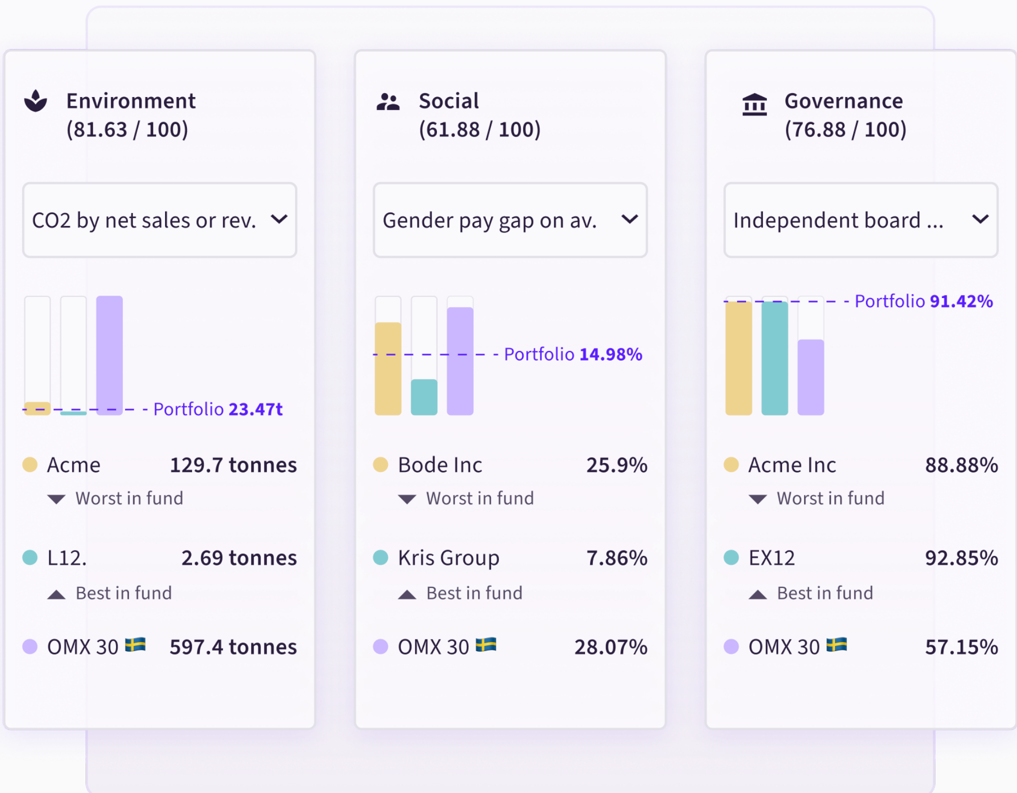
1. Follow a step-by-step guide to create a sustainable investment methodology according to SFDR
2. For each set of criteria, investors can select KPIs such as PAI indicators, SDGs contribution, controversial business involvements, etc. For each KPIs set minimum thresholds to be met by investments
3. Datia's software automatically calculates what percentage of the portfolio meets the defined methodology
4. Investors can understand in detail why each company was classified as "sustainable" or "not sustainable"



More solutions to help you tackle Sustainable Finance

Datia helps asset managers, fund management companies, asset owners, and wealth advisors with data sourcing, analysis, calculations, and reporting following the latest regulatory guidelines and frameworks. Here's how:

- 200+ sustainability KPIs including ESG scores, Business Involvments, SDGs alignment, and Principal Adverse Impact indicators
- Universe of 36,000+ companies, 210,000+ funds, and 210+ sovereign nations and the possibility of inserting your own sustainability data
- Fund look-through that enables you to find sustainability metrics of all underlying assets within complex portfolios
- Transparent and traceable data (origin, reporting periods, and links)
- Automatic calculations based on portfolio snapshots
- Public API for you to insert numerous portfolio snapshots and export an unlimited number of reports
- PAI statement ready to download in pdf or editable format, and in five languages
- Reports such as ESG Fact Sheet and End Client Sustainability Report ready to share with clients and stakeholders
- A step-by-step questionnaire that enables you to create the European ESG Template (EET) of your financial products quickly, saving up to 90% of the time you would need to create the files



About us

Datia is a climate fintech company on a mission to empower investors' transition to sustainable finance, serving asset managers, asset owners, management companies, wealth advisors and tech platforms.

Headquartered in Stockholm, Sweden, Datia has a customer network with over €200+ Billion Asset Under Management (AUM) and works with some of the most reputable investors in Europe.

We are trusted by some of the most reputable institutions in Europe

Get started