REPRESENTING ALTERNATIVE INVESTMENTS

BAI’s comments on draft ESRS Delegated Act

The BAI has intensively reviewed and discussed the EU Commission's drafts of the European Sustainability Reporting Standards (ESRS) together with its member companies, compared them with the EFRAG drafts of November 2022, and is pleased to take this opportunity to comment.

BAI and its member companies have supported the EU's Sustainable Finance Initiative and its objectives from the very beginning. However, in our initial responses, for example to the draft RTS on the SFDR in 2020, we also took the position that “the cart was put before the horse” and that the chronological order of the various EU regulations and directives in the area of sustainable finance was and is basically wrong.

The linchpin for risk management as well as for investment decisions in the field of sustainable capital investments is data: Available, reliable and resilient data on the E, S and G components. On the one hand, we have always opposed an excessive level and granularity of data to be reported in the fund industry, but have always accompanied the fundamental disclosure obligations for funds and supported them through intensive association work. This applies in particular to the PAI KPIs for SFDR and especially for private market investments in the illiquid asset classes real estate, infrastructure/renewable energies, private equity and private debt – among the most important asset classes – for a successful transformation of the European economy towards sustainability.

We emphasize that the finance and fund industry was and is willing to support the goals of EU’s Sustainable Finance Initiative – but the legislator must also provide the industry with the means to achieve these goals. However, these means are the ESG data mentioned above.

Although the CSRD/ESRS will only apply to relatively large and partly listed companies in terms of scope, the data of the companies obliged by the CSRD are nevertheless of enormous importance for the investors and asset managers who invest in them. The planned future expansion of the CSRD scope, to include smaller companies, non-EU companies and additional ESRS sets for specific industries, will slowly but steadily improve the data situation for investors and asset managers.

However, due to the significant changes in the ESRS drafts between the versions of EFRAG from November 2022 and the EU Commission consulted since 9 June 2023, the data to be published by the companies according to the CSDRD/ESRS will be drastically weakened to the detriment of the financial and fund industry.

In light of these introductory and fundamental remarks, but also in order not to thwart and jeopardise the goals of the Sustainable Finance Initiative, we ask the EU Commission for amendments that follow the following guidelines:

- The ESRS should be guided by the draft EFRAG draft in terms of more mandatory data points, compared to only optionals.
- Especially data points that are mandatory to report for the financial sector, such as in particular the PAIs according to the SFDR, should also be mandatory to report for companies in the real economy according to the CSRD/ESRS. This is very important for coherent regulation and overall coherence within the European Union’s sustainable finance framework.
- The materiality analysis should at least be reconsidered or abolished for all areas that are subject to

mandatory reporting under the SFDR. Data points that are mandatory as PAIs under the SFDR should at least be subject to a materiality analysis in so far as the company has to explain the non-materiality.

The rules and regulations of the Sustainable Finance Initiative are extremely complex, but also a coherent, consistent concept in which the various regulations are interrelated and mutually dependent. If one set of rules is weakened, the effectiveness of other sets of rules is also weakened. The painstakingly built EU sustainable finance architecture with its complex structures (from CSRD, SFDR, Taxonomy to the Green Bond Standard GBS, the consideration of ESG risks in the fund directives AIFMD/UCITS and the regulatory frameworks Solvency II and CRR II to the regulation of financial advisors according to MiFID II and insurance distribution according to IDD) would then be structurally on a shaky foundation. We do not consider the change from EFRAG's draft to the Commission's proposal, according to which, with the exception of ESRS 2, all disclosures are dependent on the materiality analysis, to be expedient.

Against this background, we specifically recommend the following:

Materiality assessment

Regardless of the outcome of its materiality assessment, a company shall always provide the disclosures required by ESRS 2 (General Disclosures). In line with EFRAG's drafts from November 2022, we recommend that ESRS are amended to require companies to always provide, in addition to the General Disclosures, (i) the climate-referenced data points that are mandatory under SFDR and that are in the same tame disclosures and data points included in the ESRS E1 (Climate Standard) via a "comply or explain" approach (companies have to report all data points or explain their non-materiality) and (ii) all disclosures and data points included in the standards if they directly meet the information needs of other parties to fulfil their own disclosure obligations under separate legislation – such as SFDR and CRR II/Pillar 3 (we have already mentioned the SFDR PAI KPIs). Our "comply or explain" approach follows the observation that ESRS E1 is quite detailed and includes many data points that are relevant to companies in different ways, e.g., Target Setting, Removals & Storage etc. I.e., companies must in principle report on all data points or justify why they do not consider this to be material.
Under SFDR, investors and asset managers must disclose PAI KPIs at portfolio level. Therefore, it is logical that the CSRD requires exactly this data from (portfolio) companies. This would have simplified data collection for investors and asset managers immensely. If data points are no longer mandatory components, investors and asset managers are directed to continue purchasing this data from ESG rating agencies and service providers that offer high-priced PAI datasets. This is particularly critical in our view because it results in a divergence in the assessment of materiality between the SFDR and the CSRD. Companies can classify the sustainability impacts to be identified with the help of mandatory PAI indicators as non-material on the basis of their own business model, whereas asset managers must always take these into account in their investment decisions within the framework of Art. 4 SFDR.

In particular, in the area of climate, all large companies should account for their contribution to climate change and their emission reduction measures. The rule provided for in the Commission's draft will allow companies to exclude this topic as non-material. This results also from the fact that requirements for the materiality analysis are also incomplete.

Within the scope of the materiality analysis and assessment, the materiality of negative impacts is to be assessed according to ESRS 1 AR 10 using the criteria "scale", "scope" and "irremediable character" (p. 23 of Annex I):

__Characteristics of severity__
AR 10. The severity is determined by the following factors:
(a) scale: how grave the negative impact is or how beneficial the positive impact is for people or the environment;
(b) scope: how widespread the negative or positive impacts are. In the case of environmental impacts, the scope may be understood as the extent of environmental damage or a geographical perimeter. In the case of impacts on people, the scope may be understood as the number of people adversely affected; and
(c) irremediable character: whether and to what extent the negative impacts could be remediated, i.e., restoring the environment or affected people to their prior state.

While "scope" and "irremediable character" can be assessed in a reasonably comprehensible way based on the definition of these terms in ESRS 1 AR 10 (see above), this is not the case for the concept of "scale". How, for example, is the "scale" of a certain level of water consumption or of CO2 emissions at a certain level to be assessed? This always depends on what this value is put in relation to. For example, smaller companies could justify the insignificance or non-materiality of the issue of GHG emissions by stating that their absolute emissions are significantly lower than those of large companies, even though they are more GHG intensive in relation to the turnover. Likewise, a water-intensive company, for example, could classify the issue of water consumption as non-material because it performs better in comparison to its direct competitors. The assessment of the "scale" of a negative impact thus always depends on the value with which a company compares itself. Clear guidance should be given here so that a uniform approach is ensured. Otherwise, many argumentative loopholes are created in order to identify issues as immaterial.

Disclosure of non-materiality assessment results

Companies are under the Commission's drafts not obliged to disclose reasoning why certain requirements are deemed non-material (cf. ESRS 1 no. 31/ESRS 2 no. 57). This is a significant change from the original "comply or explain" approach of the EFRAG's draft and allows companies to exclude entire topics from reporting without having to justify this publicly. In addition, the general motive for the simplifications in the Commission's proposal compared to the EFRAG's draft, namely the reduction of the reporting burden for companies, does not really apply: a mandatory explanation of the non-materiality of topics, as envisaged in the EFRAG's draft, hardly creates any additional burden for the reporting companies. **When doing the materiality analysis, they have to deal with all aspects for or against the materiality of a topic. In addition, they must also be able to justify to their auditors why a topic is non-material. It can be assumed that such internal company analyses are also available in written form. It would therefore only be a matter of disclosing information that is already available, but which would be very important for the desired transparency. We recommend amending the ESRS by requiring companies to disclose the outcome of the materiality assessment** (Of course, the EU Commission should specify the level of detail this justification has to have - probably not for every data point, but at least for every excluded topic / disclosure requirement. For the asset management industry, this is particularly helpful if the SFDR information does not become mandatory under the final ESRS. Then one could rely on the materiality analysis to make estimates).

Phasing-in

We recommend maintaining the timelines proposed by EFRAG. Additional phasing-in of scope 3 emissions reporting requirements for non-NFRD companies (e.g., listed SMEs) or for certain non-climate and social data points will overcomplicate the already complicated phasing-in timeline for implementation and thus delay or complicate the quality assessment of available data (e.g., stakeholders will have to work with proxies over a longer period of time).

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