

BAI Best Practices for Principal Adverse Impact (PAI) Indicators under SFDR

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I. General Remarks & Disclaimer

These Best Practices were drafted during multiple BAI Roundtables with market participants from the alternative investments industry. The purpose of the Roundtables was to discuss the current existing and draft regulatory requirements and document the understanding of some technical aspects of PAI by the participants. It is important to mention that various aspects have been controversially discussed by the participants. In such cases different views and interpretations were documented in the Best Practices. This document is not a legal opinion, a financial advice or any other regulated activity. It is a documentation of different opinions of BAI Roundtable participants and BAI disclaims any and all liability arising from actions taken in response to this document.

II. Timeline

The following timeline is applicable with regard to PAI KPIs:

SFDR effective from	10/3/2021 (no PAI to be reported until PAI RTS come into force)
PAI RTS enter into force	1/1/2023
Art. 4 disclosures (company level)	<u>Base case interpretation based on the current drafts:</u> <ul style="list-style-type: none"> • 1/1/2022-31/12/2022 (*) • until 30/6/2023 (*) <p>*Note: See EU COM letter as of 25/11/2021</p>
Art. 7 pre-contractual disclosures (fund level)	by 30/12/2022
Art. 11 annual report (fund level)	Timeline and interpretation according to Art. 4

Further PAI reporting and disclosures based on **contractual arrangements (e.g., side letters) or voluntary motivation** can be additionally made independently from the regulatory provisions above.

Currently there is an uncertainty to which extent PAI KPIs also have to be calculated for the purpose of the DNSH assessment for sustainable investments (Art. 2 (17) and Art. 2a SFDR). Art. 2a SFDR states that “[...] *the principle of ‘do no significant harm’ referred to in point (17) of Article 2 of this Regulation consistent with the content, methodologies, and presentation in respect of the sustainability indicators in relation to the adverse impacts referred to in paragraphs 6 and 7 of Article 4 of this Regulation.*”

The recent SFDR RTS on Taxonomy Disclosures as of 22/10/2021 stated that PAI have to be calculated for DNSH (“**SFDR RTS relating to the principle of Do No Significant Harm (DNSH) (which require taking into account the adverse impact indicators of Annex I of the RTS)**”). This confirms the already published proposal in the SFDR RTS as of 2/02/2021: “*The ESAs note the feedback on the preliminary DNSH proposals in the consultation paper. While acknowledging the criticism regarding the link between the DNSH disclosures and the PAI indicators, the ESAs note that the empowerment in Article 2a(1) of SFDR requires the ESAs to make the DNSH disclosures “consistent” with the adverse impact indicators developed by the ESAs under Article 4(6)-(7) SFDR. In light of this empowerment, the ESAs have proposed that DNSH disclosures in the draft RTS should take into account the adverse impact indicators proposed in Annex I of the RTS.*” Therefore, the current understanding of the BAI Roundtable is that

- PAI KPIs may be mandatory for the **DNSH of all sustainable investments** incl. Taxonomy-aligned ones
- it is currently unclear which PAI KPIs need to be calculated and in which frequency for the DNSH assessment of sustainable investments
- **periodic Art. 8 / 9 disclosures do not require quantitative PAI disclosures** but rather a qualitative description of the PAI process
- there might be a risk that if PAI KPIs are used for the DNSH purposes of sustainable investments under Art. 2 (17) SFDR, it might lead to the mandatory application of Art. 7 and Art. 4 SFDR requirements; however, the participants also discussed arguments in favor of a separate treatment of PAI for the purposes of sustainable investments (Art. 2 (17), 8, 9 SFDR) as opposed to the PAI usage for the purposes of PAI disclosures under Art. 4 and 7 SFDR.

III. Assessment Level

Real Estate

- The assessment should be made on the level of the **real estate object** (e.g., office, hotel).
- While there is no clear guidance on the required look through the real estate object onto the activities performed by the tenants, the roundtable members understand that the assessment should happen on the level of the **direct / primary activity of the real estate object**. For instance, the primary activity of an office real estate is to rent out office spaces. While some % of the office may be rented out to tenants involved in fossil fuels, another % may be rented out to tenants that are not involved into such activities. In this example the assessment would be performed on the level of the activity “renting out office spaces” and not on the level of activities performed by tenants.
- In case where real estate project investments are structured via holding companies / HoldCos or property SPVs / PropCos, a **look through** should be performed to the real estate object.
- Other specific cases (e.g., leasing business, real estate corporates etc.) might need to be assessed on a case-by-case basis. In such cases it might be required to calculate PAIs on the level of the investee company without a look-through.

The general look-through requirement is formulated in the **Recital 4 Draft RTS**:

*“For the same reason, where the investee company is a **holding company, collective investment undertaking or special purpose vehicle**, financial market participants that have sufficient information about the adverse impacts of the investment decisions of those companies should **look through to the individual underlying investments of those companies and consider the total adverse impacts arising from them**. Where they do not have such information, they cannot be considered to take into account the principal adverse impacts of their investment decisions on sustainability factors.”*

Furthermore, **Recital 5 Draft RTS** refers to PAI assessments for **project finance**. While the recital is formulated in the context of green bonds and comparable instruments, the general idea is to calculate PAI on the “project” or asset level rather than on the level of the instrument financing it:

*“In the case of investment decisions where an investment **exclusively finances a project or type of project**, such as an investment in a green bond, social bond or project bond, the assessment of the adverse impacts of the investment decisions should be **limited to the adverse impacts of the targeted project or type of project**.”*

Infrastructure

- The general look-through requirement is formulated in the **Recitals 4-5 Draft RTS – see Real Estate**. For **infrastructure projects** the assessment should therefore be performed **on the level of the real asset** (e.g., a wind turbine or a telecom tower in a project SPV or in a HoldCo). The mapping of the real asset to the SFDR PAI categories is discussed in the following chapter. The look-through can lead to methodological challenges resulting from the application of KPIs for corporates on the level of real assets. The participants discussed that generally 2 approaches may make sense, (i) the general irrelevance of the KPI for a real asset in which case different values could be used (e.g., “0”, “1”) or “N/A” or (ii) the application of the KPI on a level different from the real asset which would be on the level of the service provider/s or the SPV itself. In any case the participants agreed that a consistent approach is meaningful for all KPIs, i.e., either approach (i) or approach (ii) for all.
- However, for infrastructure **corporate finance** (e.g., a utility, a broadcast communication services provider) as opposed to the infrastructure project finance the company itself shouldn’t be considered a holding company or a SPV due to its corporate strategy, employees etc. In such cases it might be reasonable to perform the assessment on the level of the **financial instrument issued by the company** (e.g., a participation in / a loan to the company).

IV. Scope

<p>Infrastructure real assets</p>	<p>The regulatory provisions are not specific enough at this stage. The term “infrastructure” is not explicitly defined by the SFDR. The SFDR categories “investee companies”, “real estate” and “supranationals” might not seem to exactly match the characteristics of certain infrastructure real assets. Therefore, judgement might be required on a case-by-case basis where the following approach might be applicable:</p> <ul style="list-style-type: none"> • Generally, if the infrastructure object acquired directly or via a HoldCo / PropCo has physical real estate characteristics (e.g., data center, university, care home), the real estate module should apply accordingly. • In other cases, the BAI Roundtable participants developed the following guidance: <ul style="list-style-type: none"> ○ No assessment is not an option, i.e., the real asset must be always assigned to one of the existing categories. The BAI Roundtable had a uniform understanding that infrastructure real assets should be always subject to the PAI assessment. ○ Treating the real asset in the investee company category. While the majority of the attendants agree that not all PAI KPIs for investee companies are always meaningful for real assets, they are perceived as the most conservative and complete approach by some attendants since the largest number of PAI KPIs is defined for investee companies. ○ A participant argued that all real assets should generally be treated in the real estate category regardless if they have real estate
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	<p>characteristics or not. Since there is no official definition of the term “real estate” within the meaning of SFDR, interpreting “real estate” as “real assets” could be seen as an alternative route.</p> <ul style="list-style-type: none"> Participant agreed that for the sake of consistency it is advisable to use one category (e.g., investee companies OR real estate) consistently rather than mixing up different PAI KPIs from different categories in one report. This will enable the recipient / the investor to process the data in a standardized and consistent way.
Infrastructure corporates	<ul style="list-style-type: none"> As explained in the previous chapter, infrastructure corporates should be treated in the “investee company” module due to their corporate characteristics (e.g., strategic, reputational, operational risks).
Real estate object (real asset)	<ul style="list-style-type: none"> Real estate module
Real estate corporate	<ul style="list-style-type: none"> Investee company module

V. Frequency

Based on the answer to the Question 11 Draft RTS “*the ESAs propose an end of year calculation based on the average of at least four quarter-end calculations*”.

- On the **asset level** PAI KPIs should be calculated on a **quarterly basis** for the **reference period of the assessed quarter** (e.g., 1.1.23 – 31.03.23).
- It should be noted that some PAI KPIs are rather static and shouldn’t experience changes on a regular basis throughout the lifetime of an asset. For instance, the energy efficiency level or the involvement into activities related to fossil fuels shouldn’t change between quarters on a frequent basis for the most assets. In that case the **same KPI values** would have to be reported every quarter unless they potentially change.
- On the **fund level** PAI KPIs should be aggregated from the asset level KPIs on a **quarterly basis**. The quarterly values would then be aggregated as an **arithmetic average for the end of year calculation** used in the PAI statement.

VI. KPIs in Detail

The KPIs are discussed in detail in the **Annexes “BAI PAI KPI RE”** and “**BAI PAI KPI Infrastructure**”.