SFDR – One year on: Convergence is coming

How greater standardisation and transparency is set to transform ESG reporting

The private investment industry has put a great deal of effort into tracking and reporting on their sustainability efforts over the last decade or so. This has become an increasing challenge, however, as a proliferation of frameworks and objectives mean that what it means to invest sustainably isn't standardised. Recently the industry has come together to agree on a set of metrics that will form the core of ESG reporting and pave the way for meaningful standardisation, and more importantly ensure that private investments are achieving ESG goals.

ESG Reporting Challenges

The private investment industry has, by and large, been very active in implementing ESG and sustainable investing practices over the last several years. GPs are hiring sustainability specialists both internally and at portfolio companies and LPs are demanding regular reporting from their managers on progress towards ESG goals. Increasing regulation, particularly in Europe with the implementation of the Sustainable Finance Disclosure Regulation (SFDR), has accelerated this process.

Despite this progress, the industry is facing challenges in ESG reporting. There are numerous frameworks in use currently, each of which are designed for slightly different purposes and therefore use different methodologies.

The SFDR in Europe requires asset managers to disclose information on their sustainability practices and report where their operations have negative effects on environmental and social matters, their Principle Adverse Impacts. This regulation does mean that funds must demonstrate how they are sustainable and normalises sustainability reporting in the industry, but it fails to address some of the current issues with ESG reporting.

As things stand, the guidance on the methodology and content of these disclosures is not specified. The regulatory technical standards (RTS) which detail these are now due to come into force in January 2023 having been delayed three times. GPs are currently encouraged to use the draft RTS as a reference for their reporting, adding another framework to the already fragmented space.

These factors combine to mean that GPs must spread their reporting resources thinly across many ESG data requests from LPs using different frameworks in addition to the data required to fulfil regulatory requirements. The effect of this is incomplete and non-comparable ESG data and means that broad-based data on ESG performance in private investments doesn't exist.

What is the convergence project?

To address the challenges posed by the fragmented reporting standards for ESG, the private investment industry has come together to create the ESG Data Convergence Project, which launched in September 2021. The project is an industry-led partnership between more than 100 GPs and LPs and aims to streamline the collection of ESG data in the private investment industry. To do this, participating firms have agreed on a core set of metrics across six categories which will be reported on in a standardised format. In addition to being shared by GPs with their invested LPs, the data will also be aggregated by Boston Consulting Group (BCG) into anonymised benchmarks.

The goal of the project is to create a critical mass of the industry reporting standardised, performance-based ESG data that can serve as a meaningful benchmark for comparisons.

What is the project tracking?

The convergence project will initially track 15 metrics across six core ESG categories:

1. Greenhouse Gas Emissions
    a. Scope 1
    b. Scope 2
    c. Scope 3 (optional)
2. Renewable energy
    a. Percentage of renewable energy use
3. Diversity of board members

    a. Percentage of women
    b. Percentage of under-represented groups (required for US in 2021-22, optional for rest of world)
    c. Percentage of LGBTQ (optional)
4. Work-related Injuries
    a. Injuries
    b. Fatalities
    c. Days lost due to injury
5. Net new hires
    a. New hires (organic and total)
    b. Attrition
6. Employee engagement
    a. Employee survey (Y/N)
    b. Employee survey response (optional)

In addition to these metrics, the project will go through a process of identifying and adding more each year. It will survey participants to identify key priorities, which will then be discussed by steering groups alongside a review of the prior year's data. After a process of detailing any new KPIs, and ensuring they are in line with the project's guiding principles, a vote of the project participants will decide if they will be adopted.

How will the project work?

The governance of the convergence project is being finalised during this first year, but as it stands the project is overseen by steering groups, one being GP-only, one LP-only, and one collaborative GP/LP group, which has an equal representation of GPs and LPs. These groups oversee annual sprints, collaborating and negotiating on ESG data priorities which are voted on by all parties formally signed onto the project at the beginning of the process and at the end when they are finalised.

Participants in the project have access to resources for both LPs and GPs, including standardised templates for reporting and definitions of the data points to be collected. They also agree to work to a reporting timeline, submitting data for the previous calendar year by 30 April each year and participating in metric addition sprints between May and July. The data from GPs is submitted directly to their LPs invested in the funds reported on, as well as to a third-party aggregator, BCG for the 2021/22 cycle. This anonymised aggregated data will be shared with participants in the project to create a set of standardised benchmarks showing industry averages and trends over time.

What does being part of the project mean for managers?

GPs taking part in the convergence project agree to work in line with its ESG Metrics for Investor Reporting Handbook as far as possible and explain where they have deviated from it. This short handbook details what must be collected and submitted, including definitions, reportable units, and links to further sources. Participating GPs will change their internal data collection system to track the six categories of KPIs across all funds to which it will apply. The project provides standard templates for reporting data to LPs, which must be supplied when requested.

Alongside these administrative obligations, GPs taking part should encourage all their LPs to align with the convergence project. Also implicit in taking part is the agreement to be publicly associated with the effort.

Progress is being made…but it's still work in progress

There is no question that the convergence project represents a huge leap forward for the industry in its efforts to standardise data collection and reporting, but it's important to remind ourselves that we're still very much at the work in progress stage. We're some way off having a template on the table that is universally adopted by GPs and LPs, the number of participants in the project remains relatively small (when compared to the global industry) and the convergence project is not the only initiative intent on solving the standardisation conundrum, a convergence conundrum in its own right perhaps!

None of these points detract from the fact that a number of influential GPs and LPs are showing an enormous amount of determination and will to address the elephant in the room that is ESG reporting and that has to be seen as a positive.

How can you take part?

Fund managers wanting to participate in the convergence project can sign up on the ILPA website, which hosts an FAQ document and review of the project, as well as further details on it. GPs deciding to take part can fill out a survey and complete a benchmarking agreement. Once signed up, templates and guidance are available for download.

Securing a sustainable future

In the face of significant challenges to making meaningful progress towards a truly sustainable future, the ESG Data Convergence Project represents a huge step forward for the private investment industry. For the first time there is a standardised methodology and template for GPs to report ESG data to their LPs. This benefits managers, who can focus their resources on specific KPIs, and LPs, who can compare apples with apples when reviewing the ESG performance of their GPs. Both parties will also benefit from aggregated benchmarking data. Ultimately, this project can cement sustainable investing as a core part of private markets, and consequently play a meaningful part in ensuring a sustainable future for society.