POLITECNICO MILANO 1863
SCHOOL OF MANAGEMENT

TIRESIA

POSITION PAPER

TIRESIA IMPACT INSIGHT SERIES

How the Regulation 2019/2088 meets the social impact measurement practices: a comprehensive framework.

1/2021

Irene Bengo, Leonardo Boni, Roberto Randazzo, Federico Longo

Abstract

The upcoming EU Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 just came into force (10 March 2021). The Regulation will impose the compliance to environmental social and governance disclosure and reporting obligations for several financial services participants such as investment firms and investment funds. However, despite the law provides various levels of effort and different types of activities for the disclosure and reporting obligations, the positioning of investment firms and investment funds still lacks a clear pathway of application.

In particular, the Regulation hardly reconnects to the practices of social impact measurement that are currently available for financial actors to assess their environmental, social and governance contributions. Accordingly, this paper proposes to shed lights on the social impact measurement practices and procedures that financial actors may adopt depending on their positioning in the EU SFDR 2019/2088. To do this, we develop a framework that identifies features and approaches of social impact measurement that fit with any investment firms' positioning within the EU SFDR 2019/2088, helping practitioners to orient themselves in this blurred environment. The paper is thus structured

- The EU SFDR Regulation redefines the disclosure of sustainability practices of financial actors, aiming at reducing information asymmetries and the risk of greenwashing
- Financial actors are characterized by different approaches to sustainability, making impact finance a heterogeneous context
- The framework we developed aims at moving closer the EU SFDR Regulation and financial actors through social impact measurement methodologies that balance actors' strategic positioning and regulations' requirements

1. Regulatory frameworks for sustainability

1.1 Evolution of the ESG policy framework EU strategy for sustainability

ESG factors – as we know them nowadays – made their first appearance in international declarations and covenants, after World War II. The Universal Declaration on Human Rights in 1948, and the International Covenant on Economic, Social, and Cultural Rights in 1966 have set the first framework of social factors ("S") related to safeguard and respect of human rights, social rights, and cultural rights. These acts firstly expressed a large international political consensus among governing States about the definitory character of ESG factors. In fact they represented, although thorough not legally bind instruments ("soft law"), the initial milestone of the definitory path of ESG factors, which was then further developed in the 1990s with a specific focus on environmental issues ("E") and, in the last decade, on governance ("G").

The ESG framework was consolidated at the EU level, only starting from 2010, when specific mandatory rules ("hard law") were adopted and implemented[1]. The turning point in the "ESG timeline" is certainly represented by the adoption of United Nations' 2030 Agenda and the Paris Agreement. 2015 represented the milestone towards more structured sustainability policies; since then, the EU strategy has started to be deeply focused on sustainable development, leveraging the role played by private investors and companies to face global challenges and crises. Re-orienting investments towards more sustainable technologies and businesses, with a long-term vision[2], is the keystone of the EU strategy, giving rise to a pool of norms on ESG issues that already are – and will soon be – mandatory.

1.2 "SFDR" Regulation

On 27 November 2019 the EU Parliament and Council adopted Regulation 2019/2088 "on sustainability-related disclosures in the financial services sector" ("SFDR"). The innovative goal this Regulation aims to achieve is the emersion of environmental impacts and the social value generated by the financial sector, mainstreaming ESG disclosure and upgrading this

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[1] "EMAS" Regulation 2009/1221; "Timber" Regulation 2010/995; "NFR" Directive 2014/95; "Conflict minerals" Regulation 2017/821.

[2] EU Action plan on financing sustainable growth (2018); European Green Deal (2019); European green deal investment plan (2020); Next generation EU (2020).

practice from voluntary initiative of a few innovators to a precise obligation of the general market. In particular, SFDR Regulation aims to reduce information asymmetries towards investors on the integration of sustainability risks, adverse sustainability impacts and sustainable investment objectives / environmental or social characteristics promoted by the financial market participants. Such information is generally not deepened nor disclosed at all due to the lack of harmonized requirements and rules on sustainability impacts (negative or positive).

The first important step taken by the EU through the SFDR is about definitions. Specifying what is meant by Sustainability Factors ("environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters") and, more specifically, Sustainable Investment[3] and Sustainability Risk[4], the Regulation provides a clear framework concerning what financial market participants shall put in place. They are asked to:

- publish on their website information about their policies on the integration of sustainability risks in their investment decision-making process (article 3 – entity disclosure)
- publish on their websites whether they do consider or not the adverse impacts generated on sustainability factors and the due diligence policies adopted with respect to those impacts (article 4 – entity disclosure)
- publish on their websites information on how remuneration policies are consistent with the integration of sustainability risks (article 5 – entity disclosure)
- provide in pre-contractual disclosures information on how sustainability risks are integrated into investment decisions and the impacts of sustainability risks on the returns of the financial products (article 6 – product level disclosure)
- provide in pre-contractual disclosures a clear and reasoned explanation of whether and, if so, how a financial product considers principal adverse impacts on sustainability factors (article 7 – product level disclosure)
- provide in pre-contractual disclosures and periodic reports information on how the financial

[3] "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 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 labour relations, or an investment in human capital or economically or socially disadvantaged communities"

[4] "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment"

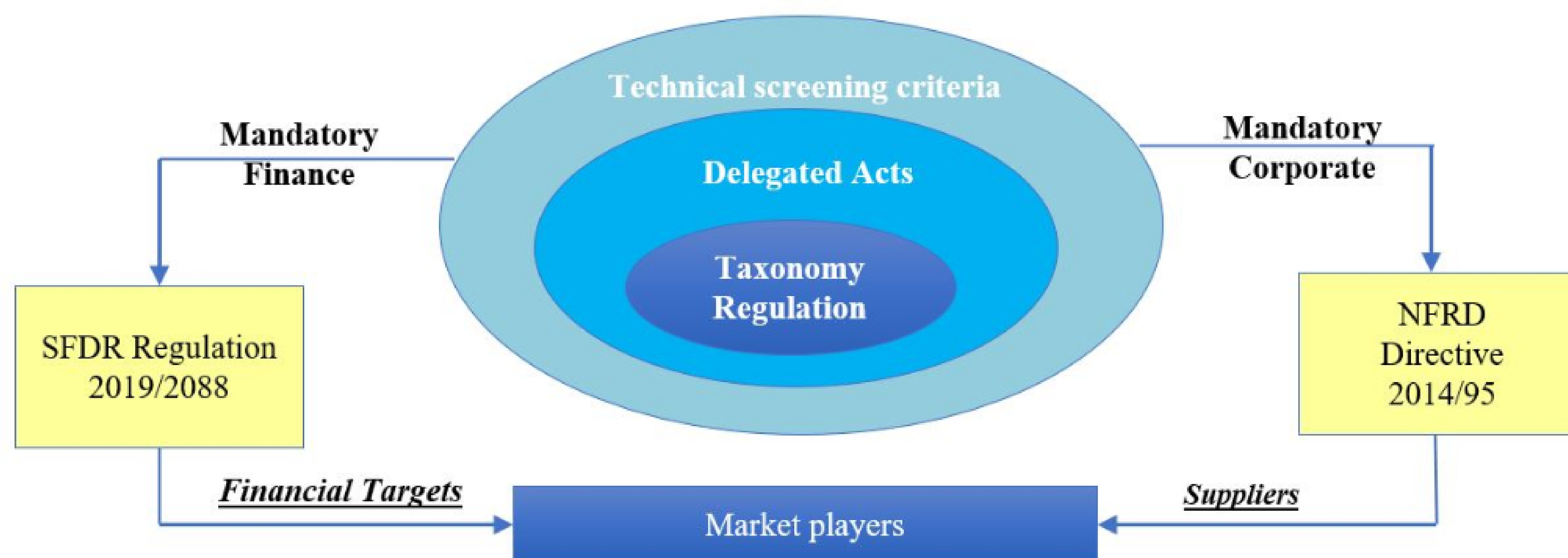
product promotes and respects social or environmental characteristics and the methodology used for measuring social or environmental characteristics (article 8 – product level disclosure)
- provide in pre-contractual disclosures and periodic reports information on how the financial product contributes to the achievement of the sustainable objective and how the sustainable goal stands out from a traditional market objective (article 9 – product level disclosure)

To be noted, the key connection between transparency and measurement generated by article 10 requiring financial market participants to publish and maintain on websites for each financial product referred to article 8 and article 9 "(a) a description of the environmental or social characteristics or the sustainable investment objective; (b) information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product". Measurement becomes then crucial as it represents the mean through which SFDR defines the classification of financial products.

1.3 "Taxonomy" Regulation

Since every measurement system requires goals and KPIs, Regulation EU 2020/852 ("Taxonomy") amending SFDR set a common language for sustainability, aligning the criteria to determine whether or not an economic activity could be deemed sustainable (EU Taxonomy provides, under article 9, a full list of environmental objectives[5] and, in the following articles, an explanation of what they mean and the actual planning for the implementation of technical screening criteria through specific Commission's Delegated Acts).

[5] (climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems)



Graph 1: EU sustainability Regulatory framework

In the EU strategy, Taxonomy plays a pivotal role around which an integrated ESG regulatory framework of binding rules will be created. So far, the Taxonomy Regulation integrates both the SFDR and the Non Financial Reporting Directive (EU 2014/95), and will be further supplemented and detailed by the EU Commission through specific Delegated Acts establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as sustainable.

Whether environmental issues are fully embedded – Green Taxonomy can be based on metrics – actual gaps of the Regulation can still be spotted concerning social objectives such as human rights, access to healthcare, decent employment, equality, non-discrimination, which necessarily shall be based on international norms, principles and goals instead of KPIs. In this regard, to be noted that the European Legislator has already defined the next steps for further expanding the scope of the Taxonomy beyond the environmental goals, including also social objectives (article 26 paragraph 2). In fact social issues are already embedded in the Regulation since article 3 requires sustainable activities to comply with the so-called minimum safeguards set by “soft law” instruments such OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Right and ILO Declaration. Therefore, social objectives are a core issue of the future Taxonomy and a specific “Subgroup on social taxonomy” of the EU Platform on Sustainable Finance is responsible for advising the Commission on extending the Taxonomy to social goals (a report on social objectives is expected by the second quarter of the year and a report on compliance with minimum social safeguards by the fourth quarter of 2021.

Accordingly, the regulatory framework for sustainability is defining a ground for the actors in the finance field that increasingly require not only to endorse social and environmental objectives, but also to engage in dedicated measurement practices. However, as for actors have been attracting to exploit sustainability as a strategic diversification approaches, the novelty of the regulatory framework requires substantial practices that coherently align the position in the market and the impacts achieved.

2. Financial actors in sustainability – Impact finance

Besides the precise trajectory identified by the regulatory system of the financial sector for the sustainable development, the actors characterizing the financial sphere are very heterogeneous. Nowadays, the context of impact finance is characterized by multiple typologies of actors that distinguish mainly for their different integration of sustainability objectives within their investment approaches. Accordingly, these actors propose to combine economic and social value from their financial activities, in what it is commonly known as blended value.

The concept of blended value reconsiders the understanding of previously separated economic and social value in an integrated approach to conceptualize the returns from investments[6]. Blended value identifies an increasingly expanding framework of investment approaches where sustainable development can act as a crucial driver of operations. Literature traditionally points at impact investors as those actors more aligned to the generation of blended value, because they typically adopt positive screening strategies, that is, investors' seek for targets that intentionally aim at generating ex-ante defined social impact[7]. On the other hand, the context of blended value is increasingly considering actors whose social and environmental commitment is less central for the investment decisions. For example, some private equity and venture capital actors propose the introduction of Environmental, Social and Governance (ESG) principles in their investment decisions,

[6] Emerson, Jed. 2003. "The Blended Value Proposition: Integrating Social and Financial Returns." California Management Review

[7] Cooper, L., Evnine, J., Finkelman, J., Huntington, K., & Lynch, D. (2016). "Social finance and the postmodern portfolio: Theory and practice". The Journal of Wealth Management, 18(4), 9-21.

to screen investment opportunities that address and are aligned with ESG issues[8]. This investment strategy is generally considered as Socially Responsible Investments (SRI)[9], to distinguish it from approaches of impact investing. SRI strategy adopts finance-first approaches to identify investment opportunities but binds target investees to be respect ESG criteria. SRI tend to minimize the negative effects of business decisions, having “partial” intentionality to the generation of social impact. Accordingly, as impact investors adopt a proactive approach about seeking social impact in their investment opportunities, ESG investors use social and environmental criteria to exclude potentially harming investees.

Within this scattered context of investment firms with different shades of blended value, the measurement approaches and the reporting practices for the social and environmental contributions mostly followed mechanisms of voluntary non-financial disclosure, without a top-down indication. However, as the new Regulations are actually introducing a top-down perspective that binds investment firms to position themselves in a precise categorization of the regulation, the voluntary approaches to the non-financial disclosure impose a measurement technique to be fully coherent with the positioning, which still lacks clarifications. The objective of this work is to shed lights on the social impact measurement approaches that investment firms can consider for their effective positioning to the novel EU regulations.

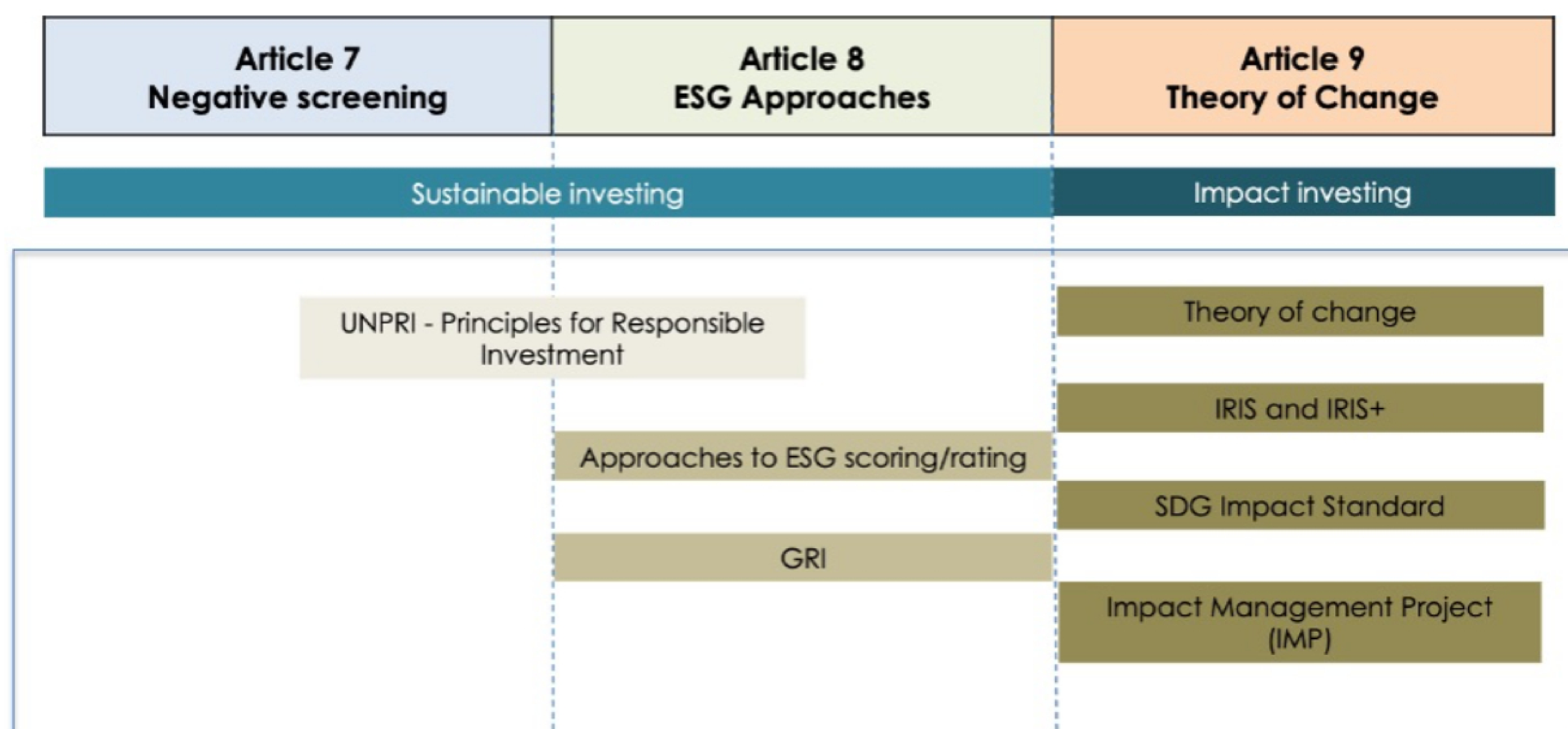
3. The missing link between UE Regulation and impact finance: social impact measurement

The lack of agreement on the definition of social impact created confusion and contrast, harming the ability to identify uniform mechanisms of measurement and reporting, and as a consequence, the straightforward identification of measurement approaches suitable for the positioning with the novel EU regulations.

[8] Eccles, R. G., Lee, L. E., & Stroehle, J. C. (2020). The social origins of ESG: An analysis of Innovest and KLD. Organization & Environment, 33(4), 575-596.
[9] EUROSIF. 2018. “European SRI Study 2018,” 1–68. https://doi.org/10.1080/14634980802171106.

However, social impact measurement is increasingly gaining momentum in non-financial disclosure mechanisms of financials actors, playing a strategic part in case investors are considering impact as the driver of organizations' mission. On the other hand, social impact measurement is becoming a mandatory practice for financial actors for their sustainability compliance duties. Accordingly, considering the importance of social impact measurement and the poor knowledge on how to make impact measurement methodologies linking with the upcoming requirements of the EU regulation, we developed a framework identifying coherent measurement tools depending on the positioning that investors adopted for their financial products.

Since March 10, 2021, financial actors are forced to position financial products within articles 7,8, or 9 of the Regulation 2088, so that understanding the coherent social impact measurement practice ensures the compliance of financial actors to the regulatory system. Thus, we identify a set of methodologies and criteria of social impact measurement that fit within the various articles of the regulation.



Graph 2: Social impact measurement methodologies that fit strategic positioning of impact finance

3.1 Article 7 and negative screening

Considering the requirements of Article 7, for each financial product, the financial market participants are required to provide disclosure on whether and how financial products consider adverse sustainability risks. If a financial market participant does not consider the negative effects of investment decisions on sustainability factors, they must publish a detailed explanation of them on their website.

Accordingly, the measurement of social impact takes a narrative shape in the reporting activities, aiming at shedding lights mechanisms of negative evaluations for certain investment opportunities. More specifically, they consider the exclusion from an investment fund or portfolio of certain sectors, companies or practices based on specific sustainability criteria; eg tobacco industry, weapons. The UN PRI criteria are an impact measurement tool that fits this framework. The UN PRI criteria are high-level guidelines that aims at defining an overall vision for investment approaches that do not harm Environment, Social and Governance (ESG) principles. Moreover, financial actors' signatories of UN PRI criteria should incorporate such principles in the internal policies and procedure, make appropriate disclosures, and promote them to peers.

3.2 Article 8 and ESG approaches

Considering the requirements of Article 8, a financial product promotes, among its characteristics, environmental and / or social characteristics, the information to be communicated must include:

1) How these characteristics are respected
2) The methodology to use for the measurement of these characteristics

The social impact measurement criteria for financial products that position within this framework require the absorption of ex-ante defined sustainability criteria that define eligible investment opportunities. Differently from what reported for Article 7, there is a positive screening approach for which the investments in selected sectors, companies or projects should obtain a positive performance under sustainability criteria compared to peers in the sector. Accordingly, this type of approaches are in line with the shade of blended value finance that proactively considers and build on Environmental, Social and Governance (ESG) approaches. There are over 1,000 ESG ratings, indices and managerial dashboard available

to assess whether organizations are compliant to the Environmental, Social and Governance issues. Among those adopted the most, we can find the Global Reporting Initiative (GRI). Using the GRI Guidelines, organizations disclose their most critical impacts, whether positive or negative, on the environment, society and the economy. The GRI generates reliable, relevant and standardized information with which to evaluate opportunities and risks and enable a more informed decision-making process, both within the company and among its stakeholders. The GRI is designed to be universally applicable to all organizations of all types and sectors, large and small, around the world.

ESG Approaches help financial products navigating investment opportunities with specific characteristics and requirements, distinguishing from business-as-usual opportunities for their relevant ESG aptitude, offering a proactive approach to sustainability.

3.3 Article 9 and Theory of Change

Considering Article 9, the requirements involve a financial product that has sustainable investments as its objective, for which an impact objective to be pursued is designated, the information to be communicated is:

1) Indicate how the investments are contributing to achieve the impact objective
2) Indicate how the impact objective differs from a traditional market objective

This type of products are suitable with the principles of blended value that recall to impact investing practices. The use of financial products for impact investing purposes involves the application of a Theory of Change (ToC) - for investment opportunities. A Theory of Change (ToC) describes how and why an investment opportunity is supposed to lead to a desired end result (environmental and / or social)[10]. Often a ToC is defined as the connection between activities and results (outputs, outcomes and impacts). The measurement of social impact through a ToC approach defines the social and / or environmental problem that a financial product aims to solve, and the context in which it is supposed to be enacted. Accordingly, the identification of a precise impact objectives makes the ToC suitable for the compliance with Article 9 of the Regulation, which assume the building of a impact measurement infrastructure that allow to report on the ex-ante defined social objective for which the

[10] Ebrahim, A., & Rangan, V. K. (2014). What impact? A framework for measuring the scale and scope of social performance. California management review, 56(3), 118-141.

financial products have been created. Within this framework, the SDG Impact Standards are a set of practices that help companies and investors aligning their activities with the SDGs, facilitate the mobilization of resources towards the generation of outcomes and impacts on the SDGs and implement ToC to identify the impact targets. The standards provide a common language and best practices that guide the achievement of social and / or environmental impacts from the screening of activities to the monitoring over time to the exit strategies. In addition, the Impact Management Framework is a coherent recipient for the application of ToC approaches, thus aligned with the Article 9 regulations. The IMP has defined five dimensions through which evaluating the impact: What, Who, How Much, Contribution, Risk. In relation to these dimensions, a set of categories has been defined to allow companies and investors to set impact targets and evaluate performances. These categories are building blocks that can be used by an organization to frame their impact picture or as a checklist to ensure they cover any elements essential to managing impact.

4. Discussion and contributions

With this article, we aim at identifying a mechanism that align the non-financial disclosure practices of financial products and the requirements imposed by the upcoming regulatory frameworks and in particular the regulation 2019/2088. We argue that mechanisms of social impact measurement play a relevant role for defining the boundaries of non-financial disclosure practices, given the lack of current guidelines to be followed. With this contribution, we provide three main implications for practitioners. First, we developed and share a comprehensive, applicable toolkit that drive the compliance to the novel regulation, helping actors involved understanding the various facets of social impact measurement. Second, we shed lights on the importance of social impact for the new era of the financial sector, hoping to stimulate the application of the social impact measurement practices not just for matters of compliance but increasingly with a strategic, value added, vision. Third, considering that regulations are evolving, and will demand for increasingly relevant sustainability-oriented practices, absorbing the social impact measurement practices from a strategic standpoint may help anticipating the market, defining a competitive positioning in the evolving financial market dynamics.

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