You need to be monitoring ESG if you have or want investors

With SFDR Phase 1 rules now in full force, it’s becoming essential for startups to know how well they’re doing on matters of environment, society and governance.

Temps de lecture : minute

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For businesses of all sizes and those that invest in them, an active approach to ESG is shifting from nice-to-have to a legal requirement. Effects are set to emerge gradually, but the wheels are in motion in an attempt to green finance from the top down. A dominant piece of legislation is the EU’s Sustainable Finance Disclosure Regulation (SFDR). Via a set of rules and a framework classifying sustainable economic activities, it’s aiming to encourage the movement of capital away from sources of harm – and towards sustainable initiatives.

“The future of finance is based on what happens now," Zsuzsanna Schiff, auditing and reporting manager at the *ICAEW*, tells me. “Firms have an obligation to consider material ESG factors, such as climate change risks and impacts, as part of their investment processes going forward.

“There is huge pressure on asset managers to show that they can comply with the requirements, not simply because of regulations, but because investors are increasingly committed to have a positive impact on climate change, natural capital and society.”

Anyone participating in financial markets in the EU, from venture capitalists to pension funds, must play their part in this push for transparency. By association – and here’s the clincher – small businesses

will be affected too. As investors make changes to conform to SFDR principles, they'll be asking those they're funding about their impacts on the environment and society, their values and supply chains.

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As of January 1st this year, Phase 1 of the SFDR is live. The principles of disclosure were published last year and, in 2022, asset managers will need to follow them. Key actions will include publishing a Principle Adverse Impacts (PAI) statement online midway through the year, and disclosing the sustainability impacts of their prospectuses before year-end.

The PAI statement will detail the major environmental causes for concern tied to their investments, and how these have been identified and are being managed. Particular attention will be paid to the prospectuses of

funds labelled as green in an attempt to prevent greenwashing. Phase 2 – which will see more detailed technical standards introduced to guide these disclosures – has been subject to delays. It is set for implementation in January 2023.

UK small businesses: what does it mean?

While certainly it's financial players and larger/EU-based corporations that will be affected most this year and next, UK small businesses need also listen up. The SFDR applies to companies doing business in the European Economic Area (EEA) irrespective of their origin/HQ location.

"This is a pervasive regulation, but in general affects financial market participants who are either based, or have investors in the EU", says Jack Spencer, an investment analyst at a large UK asset manager. "Any [UK] company which has an underlying EU investor (such as a private equity fund with an EU insurance company invested in it; or a large EU insurance asset manager providing debt funding) would need to report against PAIs for the fund invested in it."

"Disclosures can only be as good as the information asset managers receive from the investees, which will have to be reliable too", says Schiff. "It is crucial that firms pull as much data from different sources to create as full a picture as possible when formulating their portfolios and investment products, which could take a huge amount of time and effort."

There's also a UK version of this legislation – the SDR – just a few steps behind. And both this and the SFDR may be used to market financial products and services before legally enforced, meaning UK startups may be expected to report before they have to.

Challenges to come

The advice from experts is to start preparing now, as reporting will ultimately be inevitable and is currently seen as a plus. Already, startups with solid proof on ESG have a competitive advantage that translates to more access to capital, a proactive approach to risk, cost reduction and employee productivity. The problem is that – particularly while we await SFDR Phase 2 clarifications – measuring your ESG footprint is pretty difficult when time and money are scarce, as they often are for startups.

“[SMEs] mostly lack the necessary information and resources, so it will take time for them to catch up”, says Schiff. “However, as complete disclosure can only be achieved by looking at whole supply chains it will not be long before [they] are required to.”

“The impact on all investee companies is primarily time and difficulty in collecting data”, says Spencer. “For example, Scope 3 carbon emissions are very difficult to assess for most businesses, though this is not required until 2023.”

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Why do small businesses need to monitor their ESG? We spoke to the experts

The assumption is that, in the future, reporting on sustainability performance will be as commonplace and mathematical as reporting on financial performance. But short of bringing in consultancy firms and data analysts, what are the options for small businesses right now?

In much the same way that you can submit your tax return without an accountant, you can report on ESG yourself *by identifying the frameworks* relevant to your business and industry and collecting data against them. Alternatively, affordable monitoring platforms like *ESGgen* and *Diginex* are springing up with curated services for small businesses.

Away from the specificities of implementation, there are broader challenges with the SFDR's ability to incentivise a greener financial system. But it's certainly a good start.

"It is a significant step in the right direction to collecting the data required to understand the impact of different activities. There is an adage that you need to have the data to do something about it," concludes Spencer.

"However, there is almost unlimited liquidity and opportunities at the moment. This means that while some European investors may have to step back from particular sectors (and move into others), other investors will step in where the returns are attractive. I think more political action to stop activities, such as coal fire power, or oil and gas extraction, will be required to actually make changes."

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