WHITE PAPER

Classification Scheme for Sustainable Investments

Accelerating the just and sustainable transition of the real economy

This is a white paper drawn in the context of developing a future standard for SRI / ESG related market reports. This is not yet a definitive approach and is meant for discussion purposes to stimulate further thinking and developments in this area.

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1 Introduction

There has been a tremendous increase of investments in the ESG and sustainability context over the last decade—especially in Europe. The Global Sustainable Investment Alliance estimates global sustainable investments to have reached 35.3 trillion in 2020 (GSIA 2020). While such estimates are helpful to provide a broad picture about market trends, at the same time the question arises what these studies consider as “sustainable investments”. Typically, a range of different investment approaches are included and aggregated to one number. However, these statistics do not differentiate investments based on their ambition to actively support the transition towards a more just and sustainable economy. However, the shift towards actual impact is fundamental to “fully unlock the potential and the transformative power of capital markets and close the investment gap to achieve net-zero and the SDGs” (Eurosif 2021, p. 6). The Paris Agreement also illustrates the need for this shift stating that finance flows need to be “consistent with a pathway towards low greenhouse gas emissions and climate-resilient development” (UN Paris Agreement 2015, Art. 2(c)). As such, the support of private finance is essential to mitigate climate change effectively.

Different regulatory approaches to promote sustainable investments emerged in recent years, including, most prominently, the EU’s agenda for sustainable finance. Its goals include fostering transparency and long-termism and reorienting capital flows towards a more sustainable economy (European Commission 2020). The Sustainable Finance Disclosure regulation (SFDR) and the Markets in Financial Instruments Directive (MiFID II) are two key regulations to increase transparency and enable investors to reorient capital. Both regulations, however, propose an understanding of sustainable investments that would also include investments for which it remains unclear if they actually contribute to a transition towards a more sustainable economy. For example, the SFDR’s definition of sustainable investments in Art. 2(17) does not distinguish between investor and company impact, one of the basic concepts to understand how investors can achieve impact (Kölbel et al. 2020). In addition, both the SFDR and Taxonomy regulation are focused on identifying the most sustainable or green investments, with little guidance on how investors can help investees to transition. At the same time, current clarifications regarding the implementation of the SFDR introduce criteria for measuring company impact that are not very ambitious.[1] Policy recommendations provided by Eurosif also state that the SFDR might in fact increase reputational risks for financial market participants, since it "risks widening the gap between what many ESG products can actually achieve and the expectations of clients" (Eurosif 2022).

The current practice of how SI market reports are compiled as well as the ongoing regulatory efforts highlight the need for a new classification scheme for sustainable investments that has the notion of transition at the core of its logic. As such, this new scheme needs to illustrate the potential of different investment products and their investment approaches to create direct and indirect positive impacts and contribute to a sustainable transition. The purpose of this paper is to propose such a transition-focused classification for investments[2]. Our approach builds upon widely applied approaches for sustainable investment strategies by the European Sustainable Investment Forum (Eurosif), the Global Sustainable Investment Alliance (GSIA), and the United Nations Principles for Responsible Investment (PRI) and combines them with the classification proposed by the impact task force established by the G7 (ITF, 2021), which is based on Busch et al. (2021). We regard this paper as a first essential step towards developing a scheme that can serve as the classification logic in future market studies.

The paper is organised as follows: First, we introduce the dimensions and criteria that serve as the foundation for the new classification. Next, we introduce the new classification scheme and elaborate on the underlying logic. In the annex, we discuss several further aspects, including passive strategies as well as the coherence with the SFDR and MiFID II.

[1] According to the clarifications provided by the European Supervisory Authorities (ESAs) "it is possible to use the indicators for principal adverse impact to measure […] the overall sustainable impact of the financial product, e.g., by showing improvements of the investments against those indicators over time." (ESAs 2022, p. 2). If this practice were to be adopted, the requirements for measuring company impact introduced by regulation would miss important fundamentals of impact measurement. See Box 1 in the section about impact-aligned investments for details.

[2] We refer to investments or financial products as synonyms. We use these terms to refer to activities of asset owners or asset managers. We do not use these terms to describe the activities of investees (like companies or sovereigns)

2 Towards a new classification scheme for sustainable investments

2.1 Criteria defining the categories

For the new classification scheme, we cluster all categories into five overall dimensions: (1) general characteristics, (2) pre-investment strategies, (3) post-investment strategies, (4) performance measurement, and (5) documentation.

General characteristics

The underlying logic of the new classification refers to an investment's *ambition level*. The ambition level describes in how far an investment seeks to actively support the transition towards a more sustainable economy. Transition refers to the path towards the achievement of sustainable development, including the realization of the SDGs (Piemonte et al. 2019) or other sustainability goals or frameworks like the planetary boundaries or the EU taxonomy. The term refers to different levels of analysis such as the whole economy, specific sectors, financial portfolios, companies, or concrete economic activities of companies or sovereigns (Platform on Sustainable Finance 2021). An investment has a high ambition level where its objective is to significantly contribute to the transition towards a more sustainable economy. Investments without reference to a clear transition objective and the according investment processes are considered to have lower ambition levels.

Closely linked to the general ambition level is the main *objective* or the intention of an investment[3]. There are broadly three types of main objectives that we distinguish: (1) The adherence to specific personal values or norms, (2) the reduction of financial risk or improvement of financial performance, and (3) the contribution to solving real world challenges in the ecological and/or social context. The classification uses these objectives to differentiate the investment categories.

[3] Many regard the intentionality of an investment to be an important defining criterion, especially for impact investments (Hochstädter and Scheck 2015). Others criticise the concept of intentionality for being not observable and, hence, not directly measurable (Busch et al. 2021). We regard the objective to be the operationalisation of an investment's intention. We, therefore, use the term *objective*, since it describes concrete and measurable goals that reflect the intention. The other dimensions provide information on whether the objective or intention is actually implemented in the investment process.

As a final general characteristic, we distinguish between financial and impact *materiality*. Financial materiality refers to information necessary to understand the effect of sustainability matters on the financial performance of investees (Art. 29a CSRD-Proposal). Impact materiality refers to information about how an investee influences sustainability matters (Art. 29a CSRD-Proposal). Combining both concepts is referred to as double materiality.

Pre-investment strategies

Exclusions. This refers to an investment strategy through which investees or a class of investees such as sectors, companies, or countries are systematically excluded from the investment universe as they are deemed not investable (GSIA 2021, Eurosif 2021b). Those usually refer to exclusions such as product categories (e.g., weapons, tobacco) or controversial practices (e.g., animal testing or corruption) (Eurosif 2021b, PRI 2022). Typically, an exclusion strategy is driven by ethical or financial risk considerations.

Norms-based screening. This relates to an investment strategy in which investees are screened for their compliance with international norms or widely recognized frameworks of minimum business standards (Eurosif 2021b, PRI 2022, GSIA 2021). These include UN treaties, Security Council sanctions, UN Global Compact (UNGC), Universal Declaration of Human Rights and OECD guidelines (PRI 2022). Typical examples include the screening and exclusion of companies violating the principles of the UNGC or countries failing to adhere to international norms like the Paris Agreement.

ESG Integration. Definitions of the term ESG integration vary, illustrating different understandings of what this strategy entails. In its narrowest understanding, it is defined as a strategy that explicitly and systematically integrates considerations of ESG risks and opportunities into traditional financial analyses (Eurosif 2022, GSIA 2020). The PRI (2022) and Eccles and Kastrapeli (2017) use a broader understanding. In its broadest definition ESG integration comprises a variety of methods and strategies such as risk factor analysis, positive screening for certain ESG aspects, best-in-class approaches, even active ownership, and engagement (Capucci et al. 2018), and the incorporation into all processes related to investment analyses and decision-making (i.e., investor training, support by the C-Suite level, etc.) (Eccles and Kastrapeli 2017).

We follow the narrow definition of ESG integration, as it ensures a clear distinction to the other pre-investment strategies. As a result, we define ESG Integration as a strategy that explicitly and systematically integrates considerations of ESG risks and opportunities into company analyses.

Best-in-Class/Best-in-Universe/Best-in-Progress. This relates to a strategy in which a specific investee or a group of investees (e.g., companies, projects) is selected based on its positive ESG or impact performance (e.g., ESG/SDG ratings) relative to peers (PRI 2022, GSIA 2021). For example, only leading or best-performing companies within a universe (Best-in-universe) or an industry (Best-in-Class) would be selected or weighted based on sustainability criteria (Eurosif 2021b). Furthermore, investees can be selected based on their improvement regarding specific sustainability criteria or overall ESG/SDG rating over time. This is often referred to as Best-Effort or Best-in-Progress. A potential extension of this strategy could be to select investees with the best plans to improve in the future, ideally backed by evidence (e.g., intended CapEx).

Sustainability themed. Through this strategy, investees are selected based on themes that are linked to ESG issues or ecological or social outcomes such as climate change, sustainable agriculture, eco-efficiency, green buildings, gender equality, health, and more (PRI 2022, Eurosif 2021b, GSIA 2021). The definitions of Eurosif, PRI and the GSIA focus on the positive contribution that investees have on the identified sustainability themes. Our classification uses a broader understanding of sustainability themed that includes both a financial and double materiality perspective. Sustainability-themed strategies can, therefore, be implemented with both a focus on managing ESG risks and opportunities, and/or aligning with or generating positive impact.

Post-investment strategies

Engagement. Following the definitions of Eurosif, PRI and GSIA, engagement can be defined as a long-term process (Eurosif 2021b) to influence behaviour of current (or potential) investees through interactions with investors (or engagement service providers) (PRI 2022, GSIA 2021). The goals of engagement include increasing disclosure (Eurosif 2021b, PRI 2022), improving practices on an ESG issue, or changing a sustainability outcome (PRI 2022). Interactions include direct communication and discussions with investees, for example with senior management (GSIA 2021, PRI 2022).

Voting. Similar to engagement, voting is described as a long-term process (Eurosif 2021b), seeking to influence behaviour or increase disclosure of investees with regard to sustainability issues (Eurosif 2021b, GSIA 2021, PRI 2022). In contrast to engagement, the influence is based on ownership rights through (proxy) voting of shares, filing or co-filing shareholder proposals, direct roles on investee boards and board committees as well as direct control of portfolio companies, assets, or properties (Eurosif 2021b, GSIA 2021, PRI 2022, IMP 2019). The latter makes sure that the definition of voting employed here includes the use of ownership rights for both public and private equity.

Performance measurement

The fourth dimension describes the type(s) of ESG or impact performance measurements necessary for an investment to be classified into the respective category. These measurements can, for example, entail the analysis of violations against specific values or norms in business operations or through products and services (production of tobacco, alcohol, or violations of human rights, etc.). Considering the concept of materiality, performance measurements can also include measurement of ESG risks and/or opportunities, which is often implemented by ESG ratings (outside-in/financial materiality). Considering impact materiality, performance measurement also includes impact measurement. These impact measurements can either refer to company impact, defined as "change that a company's activities achieve in a social or environmental parameter" (Kölbel et al. 2020, p. 3) or to investor impact generated by the investment (activity) itself, then referring to a change in company impacts within the portfolio actually caused by the investment (activity) (Kölbel et al. 2020).

Impact measurements therefore include the measurement of changes in sustainability outcomes (either directly or via the assessment of reasonable proxies) and whether the investee and/or investor contributed to that change. Several ESG research agencies, for example, provide SDG ratings that aim to measure the positive and negative impacts companies generate through services, products, and business practices and operations. The EU taxonomy provides another example for a framework applied to defining and measuring the impact of concrete economic activities of assets or companies. It can help to plot an investee's trajectory towards meeting an environmental objective (e.g., using CapEx data) and allows to report on company impact. It is not, however, a tool to measure (potential) investor impact.

Documentation

The fifth and last dimension consists of reporting and external verification of information on the objective, investment strategies (pre- and post-investment), and performance measurements.

2.2 Five investment categories

The new classification scheme is based on five distinctive categories: (1) Exclusions-focused investments, (2) Basic ESG investments, (3) Advanced ESG investments, (4) Impact-aligned investments, and (5) Impact-generating investments (Table 1). We define sustainable investments as investments that have at least a low ambition to contribute to a sustainable transition, which applies to category three to five. The respective criteria within each dimension establish the necessary (“and”) and optional (“or”) conditions for an investment to qualify for the respective category.

Exclusion-focused investments

The main objective of exclusion-focused investments is to align the portfolio with specific personal values or norms. This objective does not comprise the consideration of financial or double materiality. Accordingly, exclusion-focused investments do not have the ambition to actively support the transition towards a more sustainable economy. As such, pure exclusion-focused investments are not considered as sustainable investments.

Exclusion-focused investments implement their objective through a focus on exclusions or norms-based screenings to align portfolios with specific values or convictions (e.g., no production of alcohol, tobacco, or pornography). No further pre- or post-investment approaches are necessary to be classified as an exclusion-focused investment.

Table 1: Classification scheme for sustainable investments.

Dimension		Criteria	Exclusions-focused	Basic ESG	Advanced ESG	Impact Aligned	Impact Generating
					Sustainable investments		
General characteristics		***Ambition level***	No	Marginal	Low	Medium	High
		Main objective	Values driven	Mitigation of ESG risks	Managing ESG risks & opportunities	Address E/S challenges	Active contribution to solving RWC (i.e., transition of investees)
		Materiality	-	Financial materiality	Financial materiality	Double materiality	Double materiality
Pre-Investment strategies	Negative screening	***Exclusions***	Based on ethical values	Based on ESG risks	Based on ESG risks	Based on negative impacts	Based on non-transformable activities
			OR	AND	AND	AND	
		Norms based screening	✓	✓	✓	Based on negative impacts	
		AND					
	Positive screening	***ESG integration***	-	Low commitment	High commitment	Focus on positive company impact through positive screening	Focus on positive investor impact through capital allocation
			OR	OR	OR		
		Best-in-class / Best-in-universe/ Best-in-progress	-	Low sophistication	High sophistication		
			OR	OR	OR		
		Sustainability themed	-	-	Financial opportunities		
					AND		OR
Post-investment strategies		***Engagement & voting***	-	-	Transparency ESG risks and opportunities	Transparency company impact	Transition objective investor impact
					AND		
Performance measurement		***Performance measurement***	-	ESG Risks	ESG risks and opportunities	Measurement of company impact	Measurement of expected and generated company & investor impact
					AND		
Documentation		***Objective***	✓	✓	✓	✓	✓
		Pre-investment	-	Short description	Detailed description	Detailed description	Detailed description
		Post-investment	-	-	Formal and regular reports	Formal and regular reports (company impact)	Formal and regular reports (investor impact)
		Performance measurement	-	At least one KPI	> one KPI on ESG matters	> one KPI on company impact + impact monitoring	> one KPI on company & investor impact + impact monitoring
		External verification	-	-	(✓)	✓	✓

To realise exclusions or norms-based screenings, exclusion-focused investments make use of performance measurements that focus on analysing violations against specific values or norms (e.g., production of tobacco, alcohol, or violation of human rights), often referred to as controversies or business involvement screenings. Regarding documentation, exclusion-focused investments report information about their investment objective. Other disclosures and external verification are not required.

Basic ESG investments

The main objective of Basic ESG investments is to mitigate ESG risks, providing an important category for the traditional focus of investors on long-term risk-adjusted returns. They have a marginal ambition to actively support the transition towards a more sustainable economy, since evidence for a positive contribution remains speculative. As such, Basic ESG investments are not classified as sustainable investments.

Regarding pre-investment strategies, basic ESG investments use exclusions and norms-based screenings that enable the mitigation of ESG risks, such as excluding the production of fossil fuels, human rights violations, or CO_2-intensive industries. Positive screenings apply ESG integration (low commitment) or Best-in-Class/-Universe/-Progress to analyse the financially material ESG risks, which can influence investment decisions. There is a low level of commitment if ESG integration is non-binding and if not all investees for which the necessary data is available are covered. ESG Integration is binding if the integration of financially material ESG factors into company analysis creates a need for action for portfolio managers. This either triggers an investment decision (e.g., divesting due to ESG risks) or an explanation by the portfolio manager. Post-investment approaches are possible, but not necessary to classify as basic ESG.

The performance measurement focuses on ESG-key performance indicators (ESG-KPIs) or ratings that measure financially material ESG risks. Examples include principal adverse impact indicators (PAIs) like GHG emissions or violations against the UNGC, and ESG ratings that normally include the measurement of ESG risks.

The documentation of basic ESG investments includes disclosing the investment objective, the criteria used in pre-investment approaches (exclusions and norms-based screening), and at least one ESG-KPI. An external verification is not required.

Advanced ESG investments

Advanced ESG investments aim to manage ESG risks and opportunities, focusing on financially material ESG issues. With a clear additional focus on opportunities, they go beyond the pure risk mitigation perspective that basic ESG investments pursue. While the transition towards a more sustainable economy is not the explicit purpose of such investments, advanced ESG investments could still support it when a sustainable transition goes hand in hand with managing ESG risks and opportunities. Consequently, the ambition to actively support the transition towards a more sustainable economy is not the main objective of advanced ESG investments.

To manage ESG risks and opportunities, advanced ESG investments apply both exclusions and norms-based screenings, such as excluding the production of fossil fuels, human rights violations, or CO_2-intensive industries. In contrast to Basic ESG investments, they apply stricter rules for positive screenings through, for example, ESG integration (high commitment). A high level of commitment refers to ESG integration that is binding and that includes an analysis of financially material ESG factors for all issuers in a portfolio - provided the necessary data is available. Alternatively, they can also use Best-in-Class/-Universe/-Progress, or sustainability themed approaches to implement mandatory restrictions of investment decisions based on financially material ESG issues. At least one of these positive screening approaches needs to be implemented for an investment to be classified as advanced ESG in this dimension.

In contrast to basic ESG investments, advanced ESG investments use engagement or voting with the aim to collect data and supporting research, improving public disclosure, or improving practices on ESG issues, all with a focus on improving the measurement and management of ESG risks and opportunities.

The performance measurement focuses on measuring ESG risks and opportunities. Examples include ESG-KPIs or ratings that measure financially material ESG issues, like the PAIs (e.g., GHG emissions or violations against the UNGC principles), and ESG ratings that focus on the measurement of ESG risks and opportunities.

Advanced ESG investments document the investment objective and provide a detailed description of the pre-investment approaches. They also provide formal and regular reports of their post-investment strategies, including both engagement and voting. Their performance measurement needs to be reported through more than one ESG-KPI, like GHG emissions, other PAIs/KPIs or an ESG score. Ideally, external verification of the sustainability data or investment approach is provided.

Impact-aligned investments

In contrast to basic and advanced ESG investments, this category includes the double materiality perspective. The objective of impact-aligned investments is to address environmental and social challenges and to align with internationally accepted goals such as the SDGs. In order to realize this, they focus on investees that have already realized positive company impact (see below). This includes, for example, investments that select companies whose GHG reduction already are Paris-aligned, without a contribution by the investor (e.g., as implemented by the EU Paris-Aligned Benchmark). Accordingly, impact-aligned investments are considered to have a medium ambition level to actively support a transition towards a more sustainable economy.

Impact-aligned investments implement both negative and positive screenings to address environmental and social challenges and goals. Exclusions and norms-based screenings exclude investees with negative impacts, like fossil fuels or violations of human rights.[4] The positive screening approaches select investees with positive impacts on environmental or social factors, for example, using the SDGs or the EU taxonomy as reference frameworks (positive company impact). Possible positive screenings include Best-in-Class[5]/-Universe/-Progress or sustainability themed approaches. ESG integration is possible, but not necessary for an investment to be classified as impact aligned.

Impact-aligned investments also use engagement or voting as post-investment strategies. The focus here lies on the goals to collect data and supporting research, as well as improving disclosure, both with regard to the achieved positive and negative impacts of investees. Since impact-aligned investments aim at a portfolio of investees that already have positive

[4] These examples are very similar to examples mentioned for exclusions-focused investments or basic and advanced ESG investments. The difference here is that, for impact-aligned investments, the underlying performance measurement assess company impacts.

[5] We realise that best-in-class approaches are usually not considered to be connected to impact investments. The best-in-class approach itself does, however, only prescribe the group of investees that serves as a comparison in investment decisions (e.g., a sector). As long as the underlying performance measurement of investees qualifies as impact measurement, best-in-class approaches can also be applied by impact-aligned investments.

sustainability impacts, post-investment strategies focusing on improving investees practices on ESG issues, or changing a sustainability outcome are not necessary, but possible.

The performance measurement of impact-aligned investments captures the generated impacts of investees (“company impact”), providing the information necessary to select investees with positive impacts. These impacts need to refer to ecological or social objectives based on science or accepted sustainability frameworks like the SDGs, planetary boundaries, or human rights. There are many measurement approaches for company impact, both in public and private markets (Corvo et al. 2021, DVFA 2020, Grieco et al. 2015). The Impact Management Platform (IMP, former Impact Management Project) provides an example for specific criteria regarding the measurement of company impact (see Box 1 for details). Another approach to measuring company impact is proposed by the EU’s Platform on Sustainable Finance (PSF) (see also Box 1). Impact-aligned investments also need to monitor the positive impacts of their investees regularly.

Impact-aligned investments document the investment objective and provide a detailed description of the pre-investment approaches. They also provide formal and regular reports of their post-investment strategies, including both engagement and voting. For impact-aligned investments, these reports need to include information about the positive impact generated by investees and the monitoring process. Impact-aligned investments also need to provide external verification of their impact data and their investment approach.

Box 1: Summary of IMP's and the PSF's Approach for Measuring Company Impact[6]

Summary of Criteria for Measuring Company Impact Based on IMP Consensus

1. The underlying sustainability metrics used need to measure changes in well-defined sustainability outcomes (or measures of inputs, business activities or outputs that provide reliable proxies for the direct measurement of outcomes) over time (IMP 2022b, IMP 2022c).
2. The underlying sustainability metrics need to be chosen based on the relevance for affected stakeholders and/or the condition of the natural environment (IMP 2022b).
3. Impact measurements must make use of absolute social or ecological thresholds to determine whether a change in a specific sustainability metric over time is positive or negative (IMP 2022c).
4. Impact measurements need to use allocation methodologies, where possible and necessary, to establish organisation-specific targets for concrete sustainability metrics (IMP 2022c).
5. Impact measurements need to estimate whether the positive/negative change measured is caused by the investee's activities, e.g., through estimating a counterfactual (IMP 2022c).

EU Platform on Sustainable Finance: Approach to Measuring Transition of Economic Activities

In its report regarding an extended environmental taxonomy, the PSF introduced three levels of ecological performance for economic activities (Platform on Sustainable Finance 2022):

1. Substantial contribution
2. Intermediate performance
3. Significantly harmful performance

Based on and extending the current Taxonomy regulation, the three performance levels are distinguished using substantial contribution and do no significant harm (DNSH) thresholds. The performance levels can be used to describe transitions of economic activities:

1. Substantial contribution transitions: An economic activity transitions from significantly harmful or intermediate performance to substantial contribution performance. This also includes improving the performance of economic activities that already substantially contribute to one of the environmental goals of the Taxonomy.
2. Intermediate transitions: An economic activity transitions from significantly harmful to intermediate performance or increases its intermediate performance, without reaching substantial contribution yet.

Both frameworks (IMP and PSF) might be very helpful to measure the change that a company's activities achieve in a social or environmental parameter" (Kölbel et al. 2020, p. 3).

[6] Backing these criteria are major institutions like the OECD, the IFC, the World Bank, the United Nations Environmental Program Finance Initiative, or the United Nations Development Program that base their SDG Impact Standards on this consensus. Most of these organisations have discussed impact measurement and evaluation practices in detail in the last decades, especially with regard to development finance. In addition, many private market actors have committed to and use the consensus established by the IMP.

Impact-generating investments

Impact-generating investments actively contribute to solutions for social and/or environmental real-world challenges. Consequently, they take into account a double materiality perspective and have a high ambition to support the transition towards a more sustainable economy.

In their pre-investment approaches, impact-generating investments focus on capital allocation as a mechanism of investor impact to positively influence the impacts of investees (Kölbel et al. 2020; Heeb and Kölbel 2020). This includes both increasing positive or decreasing negative investee impacts. Negative screenings exclude non-transformable economic activities, for example as defined by the EU's Platform on Sustainable Finance report on an extended environmental taxonomy (Platform on Sustainable Finance 2022). ESG integration is also possible, but not necessary for an investment to be classified as impact-generating.

Regarding post-investment strategies, impact-generating investments can also use both engagement and voting as mechanisms for investor impact with a clear transition objective, i.e., the goal to positively change ecological and/or social outcomes. Engaging or voting on governance aspects can serve as an enabler for this change. They can also aim to collect data and support research, improve public disclosure, or improve practices on ESG issues, but these goals are not a sufficient condition to be classified as an impact-generating investment. If implemented, both engagement and voting need to be based on a formalised process, including an escalation strategy and divestment as an ultimate step.

The performance measurement of impact-generating investments captures the expected and generated ecological and social impacts on both levels, company and investor impact. Again, these impacts need to refer to ecological or social objectives based on science or accepted sustainability frameworks like the SDGs, planetary boundaries, or human rights. Impact-generating investments differ from impact-aligned investments in that they aim to actively change investees' impacts through investor activities. To provide evidence of their influence, impact-generating investments need to measure their investor impact, both for capital allocation and engagement strategies (see box two for examples of approaches for assessing investor impact). The success of these strategies needs to be monitored regularly. In their engagement processes, for example, impact-generating investments need to hold the investees accountable for the transition towards ecological or social targets.

Impact-generating investments document the investment objective and provide a detailed description of the pre-investment approaches. They also provide formal and regular reports of their post-investment strategies, including both engagement and voting. For impact-generating investments, these reports need to include information about the positive impact generated by investees and the investor itself including the monitoring process. The impact measurement needs to be reported through more than one KPI that measures investee and investor impact. Examples for reporting company impacts include the Paris-aligned reduction of GHG emissions or violations against human rights. Examples for KPIs assessing investor impact are provided in GIIN's COMPASS methodology (see box two). Impact-generating investments also need to provide external verification of their impact data and their investment approach.

Box 2: Examples for Assessing Investor Impact

IMPs Investor Contributions:

The IMP developed different types of investor contributions (IMP 2019), including concrete indicators (IMP 2021):

1. Signal that impact matters
2. Engage actively
3. Grow new or undersupplied capital markets
4. Provide flexible capital

As a starting point, impact-generating investments can classify their investor activities based on the IMP's investor contributions, including evidence for implementing these contributions.

COMPASS Methodology by the GIIN:

The Global Impact Investing Network (GIIN) developed the COMPASS methodology to assess and compare possible measures of investor impact (GIIN 2021). It introduces three analytical figures:

1. Scale (to understand the scale of impact results)
2. Pace (to gauge the pace of change achieved)
3. Efficiency (to compare the efficiency of pursuing impact of different investment strategies)

The COMPASS methodology provides a useful tool for investors that want to assess their impact performance.

3 Conclusion and Outlook

This white paper develops a classification of sustainable investment categories based on their ambition to contribute to a more sustainable economy. This is important since both established classification schemes for investment categories as well as the EU sustainable finance regulation (SFDR, MiFID II) do not have transition as their focus. We include existing sustainable investment strategies like exclusions or engagement as defining criteria and combine them with further dimensions from the classification proposed by the impact task force established by the G7 (ITF, 2021), which is based on Busch et al. (2021). Regulatory approaches like PAIs and the EU Taxonomy alignment can be smoothly integrated into our five categories (see Annex B).

It is important, however, that we do not understand our classification to be an implementation tool for regulatory requirements. Its aim is rather to illustrate how investments accelerate the just and sustainable transition of the real economy. As such, it captures the transition contribution of different investment approaches based on the notion of investor impact. It goes beyond the current ability of concepts used in the SFDR, the EU Taxonomy and MiFID II which focus predominantly on identifying companies that are already sustainable, aligned, or have a positive company impact. Nevertheless, the information disclosed due to the EU Taxonomy, SFDR and MiFID II still provide important building blocks that can be used to apply our classification.

An important next step is to develop a more detailed assessment system to evaluate which investments qualify for which of the classification’s categories.

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Annex A: Passive investing strategies within the classification

Theoretically, passive strategies have the potential to qualify for each of the described categories, if processes are employed that allow them to achieve the overarching investment objective and fulfil the necessary conditions. We discuss along the pre- and post-investment strategies why this might be difficult for passive investments.

Investors following passive strategies rely on index funds or exchange-traded funds (ETFs). These kinds of products follow a different investment philosophy and—due to their structure—are subject to different considerations regarding the incorporation of sustainability issues than actively managed funds. We briefly analyse three characteristics that are inherent to passive investments and are substantially different to active funds: no discretionary investment decisions, the replicated index and method of replication, and (normally) engagement and voting.

Passive investing strategies are defined as "a rules-based investment approach that does not involve **discretionary investment decisions** (PRI 2019)". Although discretionary[7] decisions are not part of passive strategies or are limited, replicating an index involves active decision in terms of choosing an index[8]. Investors can choose to replicate an index that incorporates ESG issues or that addresses environmental and/or social challenges. For example, indices can employ a rigorous ESG integration (high commitment) and, in addition, remove specific issuers associated with controversial weapons, tobacco and human rights violations or specific ESG risks, thereby classifying as an advanced ESG investment in its pre-investment strategies. In practice, indices are sometimes constructed based on the ETF managers' needs, which may result in an involvement of ETF providers in the index construction. This, in turn, could be seen as a kind of discretionary investment decisions (with the exception that they are set-up in creation of the ETF). Furthermore, the index construction itself could have elements that are near discretion or at least permits flexibility such as, for example, a fast exit-rule or a regular

[7] In the European Union, the majority of ETFs are issued as UCITS and therefore are regulated by the UCITS Directive (ESMA 2012). First and foremost, those ETFs intend to replicate the performance of an index which they either do physically, synthetically, or in a combination of both replication methods (ESMA 2012). However, some ETFs aim at outperforming an index and are not index rule-based in which the manager exercises discretion. As those ETFs do count as actively managed, we exclude them from the universe of ETFs that we discuss in this chapter.

[8] The constituents of the index itself can be of any nature—be it broad based large cap companies or just a few thematic small cap—i.e., the portfolio of an index can vary a lot.

rebalancing with particular rules that finally lead to a change of constituents linked to pre-defined specific (public) ESG-characteristics. Through this, it is possible to exclude investees based on sustainability-related aspects (e.g., exclusion due to violations of UN Global Compact principles). For this purpose, corresponding rules must be defined in the index methodologies (see, e.g., Stoxx & Quontigo 2022). Therefore, the level of index construction is essential in evaluating passive strategies.[9]

Following that logic, passive strategies can meet requirements of the respective category regarding the dimension 'pre-investment strategies'. However, as indicated above, in order to qualify as an Advanced ESG, Impact-aligned or Impact-generating investment there are further necessary conditions, especially with regard to post-investment strategies.

The mechanisms that have the highest potential to generate impact such as providing flexible or new capital (Heeb and Kölbel 2020) do normally not apply in the case of passive investment. Caldecott et al. (2022) argue that without discretionary choice, passive strategies are unlikely to affect the cost of capital as they do not have the means to feature and overweight (or exclude or underweight) specific sustainable (or unsustainable) investees. If the underlying index is very selective, there can be effects on cost of capital if capital is allocated to that index through passive strategies on this index. It furthermore strongly depends on how much flexibility the index allows with regard to discretionary decisions like pre-defined elements in the rules-based index construction process, i.e., exclusion of investees in case of controversies or if the investee no longer fulfils impact criteria.

While we have briefly analysed issues to be addressed at the index level, the second important aspect involves the **replication technique**. Asset managers can choose to physically or synthetically replicate, or to combine both. A combination of physical and synthetic or fully synthetically replicated ETFs raises the issue of transparency (ESMA 2012). In addition, synthetic replication involves the use of derivatives and its techniques like swap contracts and

[9] Take as an example a very broad index like "MSCI World ESG screened" with more than 1400 constituents vs. an index of very selective companies with strong links to sustainability like the "Global Challenges Index" with 50 companies.

its respective counterparties, involving further debate on derivatives and sustainability. This is a complex debate and out of the scope of this brief discussion.[10]

The third major difference to actively managed funds includes the possibility to use **ownership rights or to engage**. Whether a passive investment can qualify as advanced ESG, impact-aligned, or impact-generating investments depends on the implementation of post-investment strategies as necessary conditions of these three categories. Caldecott et al. (2022, p. 22) emphasise that passive strategies lead to a "different relationship with firms, which can alter potential impact and available transmission mechanisms". Based on the nature and investment philosophy of index funds or ETFs, they usually do not involve the use of ownership rights (e.g., voting) or engagement—as this would increase the cost structure. However, in the case of a physically replicated index fund, voting should be possible in principle. For example, if asset managers as a whole (on the institutional level) exercise their voting rights on environmental and social issues and are able to prove that the voting rights of the ETFs' constituents are also integrated in these overall proxy votings, the conditions for voting as post-investment strategy might be fulfilled.

Besides voting, ETF managers can engage with investees in the underlying index, if they are willing to accept higher costs for establishing and managing an engagement process. They can, for example, engage in collecting data and supporting research, improving public disclosure, or improving practices on ESG issues, fulfilling the necessary conditions for the post-investment dimension for advanced ESG investments. ETFs can also be classified as impact-aligned investments in their post-investment strategies, if they engage to collect data and support research or improve public disclosure on positive as well as negative impacts of the investee. Engaging with the goal to transform - which is a requirement for impact-generating investment—is more difficult. Even if ETF managers would be willing to establish and manage a formalised engagement process—despite higher costs—an effective engagement process should include divestment—which is difficult due to the rules-based nature and lack of discretionary decision. The index provider would have to be convinced to exclude the respective position. However, as already indicated, sometimes the index is constructed for the ETF provider increasing discretion due to involvement into index construction. Furthermore,

[10] Depending on whether the derivative is a standardised or OTC product—they differ with regard to their nature, complexity and involved counterparties. Hence, a thorough reflection of sustainability aspects must be made—including the even more indirect nature of impact.

the underlying index might allow flexibility based on defined rules, such as the described fast-exit rule. The question is further, if there are other forms of engagement such as collaborative engagement in which ETF managers can participate in and by that means support the transition of companies to net-zero or sustainable development leading to investor contribution—that is a requirement for impact-generating investments.

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Annex B: Classification compared to regulatory categories (SFDR, MiFID II)

Since March 10th, 2021, financial market participants need to adhere to reporting requirements introduced by the sustainable finance disclosure regulation (SFDR). The SFDR classifies investments into Article 6, 8, and 9 products. In addition, in its delegated regulation, the EU Commission updated the Markets in Financial Instruments Directive (MiFID II) and added an investment firms' obligation to include clients' sustainability preferences in the suitability assessment (MiFID II, 2021). This section explains how the five categories of our classification relate to SFDR and MiFID II categories.

Sustainable Finance Disclosure Regulation (SFDR)

Article 6 products integrate sustainability risks into their investment decisions (Art. 6 SFDR). This is in line with the requirement for management and investment firms as well as alternative investment managers to integrate sustainability risks into their due diligence, as introduced by a new delegated directive and regulation (EU 2021a, EU 2021b). Article 6 products therefore most likely classify as basic ESG investments, since their main objective, pre- and post-investments strategies, as well as performance measurement and documentation focuses on the mitigation of ESG risks.

An article 9 product has "sustainable investment as its objective" (Art. 9 SFDR). The SFDR defines sustainable investment as "an investment in an economic activity that contributes to an environmental objective, [...] or an investment in an economic activity that contributes to a social objective, [...] provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices"[11] (Art. 2(17) SFDR). According to the EU Commission's answers to questions raised by the ESAs, article 9 products are supposed to only invest in sustainable investments (EU 2021c)[12]. Since the SFDR

[11] The SFDR's definition of sustainable investment does not clearly distinguish between investments as the activity of asset owners/managers, and investments as the activity of investees. This is at the core of why it is currently not able to clearly differentiate between investor and company impact or impact-aligned and impact-generating investments.

[12] There is still a discussion of what "sustainable investments" will mean in practice based on the level II regulatory technical standards. Especially with possibly different understandings of sustainable investments according to the SFDR (Art. 2(17)) and environmentally sustainable investments according to the Taxonomy regulation (Art. 2(1)).

does not clearly distinguish between investor and company impact and does also not introduce explicit criteria for measuring investor impact, article 9 products can be classified as either impact-aligned or impact-generating investments, depending on the concrete implementation.

An article 8 product "promotes, [...] environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices" (Art. 8 SFDR). Article 8 products can take several forms. They can include a minimum proportion of sustainable investments (either with an environmental or social goal). In this case, article 8 products can be classified, at least partly, as impact-aligned or generating, again depending on the concrete implementation (see arguments for article 9 above). If article 8 products do not include a minimum share of sustainable investments, they can be classified as exclusion-focused, basic, or advanced ESG investments, as long as the respective sustainability-related requirements of our classification are fulfilled and promoted.

Our classification can also help to provide information necessary to adhere to current supervisory guidance provided by the European Securities and Markets Authority (ESMA). The ESMA published a supervisory briefing to provide guidance to national supervisory authorities (or National Competent Authorities, NCA) for supervising the disclosure standards introduced under SFDR (among others) and to promote convergence (ESMA 2022). They argue, that "The use of terms such as "ESG", "green", "sustainable", "social", "ethical", "impact" [...] should be used only when supported in a material way by evidence of sustainability characteristics, themes, or objectives that are reflected fairly and consistently in the fund's investment objectives and policy and its strategy as described in the relevant fund documentation." (ESMA 2022, p. 9). Our classification provides the means to examine whether claims made in the funds' name are actually implemented in its objective and investment process.

Referring directly to impact or impact investments, the ESMA also states that such terms "should be used only by funds whose investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return" (ESMA 2022, p. 9). With the impact-aligned and impact-generating categories, our classification can help to communicate an impact-related main objective (intention) clearly. At the same time, the classification goes further by providing concrete criteria for the investment processes that are necessary to implement this main objective. Therefore, our classification establishes a helpful framework to communicate an investment's impact characteristics in adherence with current supervisory guidelines by the ESMA.

Markets in Financial Instruments Directive (MiFID II)

According to the delegated regulation, sustainability preferences are defined based on three characteristics of financial instruments:

1. Minimum proportion of EU Taxonomy-aligned investments: "a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852" (Art. 1 MiFID II 2021).
2. Minimum proportion of sustainable investments (SFDR): "a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088" (Art. 1 MiFID II 2021).
3. Consideration of PAIs: "a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client;" (Art. 1 MiFID II 2021).

Financial products that include (environmentally) sustainable investments will most likely be classified as either impact-aligned or impact-generating investments, depending on their concrete implementation. A financial product can, for example, aim to align its portfolio with high proportions of (environmentally) sustainable investments, without aiming to actively increase the positive impacts (i.e., the proportion of taxonomy aligned activities)[13] of the investees (impact-aligned investments). An investment in, for example, private equity markets can use a majority stake to change business activities so that the proportion of taxonomy-aligned activities of the investee increases, qualifying as an impact-generating investment if all other necessary conditions are fulfilled as well.

Classifying a product that considers PAIs into one of the categories is more complex. It can qualify as an impact-generating investment, in case it aims at reducing an investee's negative impact through pre- and post-investment strategies (e.g., paris-aligned reductions of GHG

[13] In case that an increase in taxonomy-aligned activities lead to increased positive or decreased negative sustainability impacts. For power generation based on gas or nuclear energy, this is the subject of debate.

emissions). In this case, it would also need to measure the impact of both the investee and investor. At the same time, a product considering PAIs can be classified as an impact-aligned product in case it aims to select investees that already have positive social or ecological impacts. In this case, investees with negative impacts would be excluded. Again, to qualify as impact-aligned investment, the product would need to measure the investees' impacts, in this case based on the PAIs.[14] In case a product considers PAIs to measure and manage ESG risks (and opportunities), and implements the respective necessary conditions, it can also be classified as basic or advanced ESG investments. Last but not least, since the clients determine the elements that demonstrate the consideration of PAIs, a product considering PAIs can also be classified as an exclusion-focused investment. If, for example, a client wants to exclude human rights violations and the production of controversial weapons based on individual values, this investment could qualify as an exclusion-focused investment.

This short comparison with the SFDR and MiFID II categories shows that our classification provides information that the regulatory categories are lacking. Our five categories provide a more detailed and coherent framework to classify and analyse investments according to their ambition to contribute to a sustainable transition.

[14] Based on established criteria of company impact measurement as described by the IMP (see Box 1 in the white paper), measuring the PAIs themselves and their change over time would not qualify as an impact measurement. Ignoring such standards can increase the risk of impact-washing accusations.

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