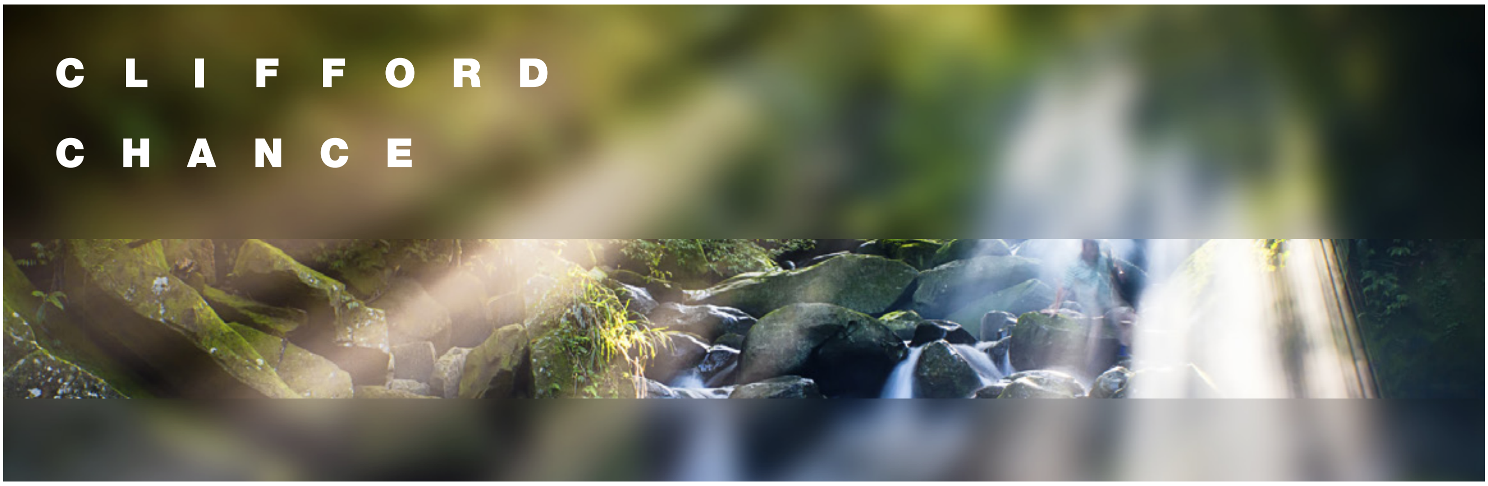

SUSTAINABLE FINANCE: EUROPEAN COMMISSION CONSULTS ON HOW INSURERS AND ASSET MANAGERS INTEGRATE 'SUSTAINABILITY' INTO THEIR OPERATIONS

The European Union has taken another step to promote sustainable finance by the publication on 8 June 2020 of draft legislation requiring insurers and asset managers to integrate 'sustainability' - environmental, social and governance (ESG) considerations - into their investment, advisory and disclosure processes. Six draft delegated acts have been published for consultation, which would amend the UCITS, AIFMD, MiFID, IDD and Solvency II frameworks. The consultation closes on 6 July 2020.

This is one of the latest milestones to deliver on the 2018 Sustainable Finance Action Plan. One aim of the Action Plan was to clarify the duties of asset managers, insurance companies and investment or insurance advisors with respect to the 'sustainability risks' associated with a particular investment, broadly speaking environmental, social or governance issues that, if they occur, could have a material negative impact on the value of the investment.

The proposed legislation amends the sectoral frameworks and aligns with and supports other key ESG legislation, namely the Disclosure Regulation, the Regulation on the EU Climate Transition Benchmarks and the EU Paris-aligned Benchmark and the Taxonomy, which aim to integrate ESG (sustainability) considerations into investment, advisory and disclosure processes in a consistent manner across all sectors. Publication of the draft legislation follows a consultative process that began in May 2018 and technical advice from ESMA and EIOPA in April 2019, on which the proposals are based.

UCITS and AIFMD

A delegated directive amends UCITS Organisation Directive, and a delegated regulation amends the AIFMD Regulation (AIMFR)

The proposed legislation modifies the UCITS and AIFMD regimes to confirm the requirements for UCITS management companies and AIFMs (Managers) relating to sustainability risks. The draft texts proposed by the Commission broadly reflect the technical advice from ESMA in its Final Reports back in April 2019, although the Commission has placed more of a focus on conflicts of interest.

The proposed approach will require Managers to include consideration of sustainability risks both at the level of the Managers' own organisational requirements and at the level of their funds' investment due diligence. As a result, managers will need to review existing policies and procedures to ensure that consideration of sustainability risks is sufficiently embedded, although for many managers this will represent a formalisation of existing practices as opposed to a wholesale change in approach to sustainability.

The proposed requirements under the UCITS and AIFMD regimes are broadly aligned and include:

- **Organisational requirements**: a requirement for Managers to take into account sustainability risks when complying with the organisational requirements in the UCITS Organisation Directive and AIFMR.
- **Resources and expertise**: a requirement for Managers to retain the necessary resources and expertise for the effective integration of sustainability risks.
- **Senior management:** a requirement for senior management to be responsible for the integration of sustainability risks into their activities.
- **Conflicts of interest**: a requirement for Managers to ensure that, when identifying the types of conflicts of interest that may damage the interests of a UCITS or AIF, those Managers include conflicts that may arise as a result of the integration of sustainability risks into their processes, systems and internal controls.
- **Due diligence**: a requirement for Managers to take into account sustainability risks in their investment due diligence.
- **Risk management policy**: a requirement for risk management policies to include procedures that enable the Manager to assess each UCITS' or AIF's exposure to sustainability risks.
- **UCITS management**: in respect of UCITS, an overarching requirement for investment companies to integrate sustainability risks into the management of UCITS (taking into account the nature, scale and complexity of the business of the investment companies).

MiFID II

A delegated directive amends MiFID II Product Governance Directive and a delegated regulation amends the MiFID Organisational Requirements Regulation

The amendments to the MiFID regime focus on sustainability considerations for manufacturers and distributors, and sustainability considerations relating to investment advice and portfolio management and again broadly reflect the 2019 ESMA advice, although again with a greater emphasis on conflicts of interest. As with the changes to the UCITS and AIFMD regimes, investment firms may find that the requirements necessitate their existing best practice to be formalised and embedded as opposed to a wholesale change in approach, although for many firms the client reporting requirement will be new.

In summary, the amendments relate to:

- Amending the MiFID II Product Governance Directive to confirm that:
  - **Manufacturers** must consider sustainability preferences when specifying the types of clients for whose needs, characteristics and objectives the relevant financial instrument is compatible with.
  - **Distributors** must ensure that the products and services that they intend to offer or recommend are compatible with the needs, characteristics and objectives, including sustainability preferences, of the identified target market.
- Amending the MiFID II Organisational Requirements Regulation to confirm that:
  - **Assessment of sustainability preferences**: investment firms providing financial advice and portfolio management should carry out a mandatory assessment of sustainability preferences of their clients and take these preferences into account in the selection of the financial products that are offered to these clients.
  - **Client reporting**: investment firms must prepare a report to the client that explains how the recommendation to the client meets that client's sustainability preferences (ex-post information disclosure).
  - **Organisational requirements and risk management policies**: investment firms must take into account sustainability risks when complying with organisational requirements and integrate sustainability risk into risk management policies.

IDD

A delegated regulation amends the product governance and conduct of business rules for insurers and distributors of insurance-based investment products.

The amendments to the IDD regime focus on sustainability considerations for insurers and insurance distributors relating to product oversight and governance and information requirements and conduct of business rules.

The amendments modify the IDD in two ways:

- **Product suitability assessment**: Sustainability factors must be integrated into product suitability assessment. Under the existing IDD framework, insurance intermediaries and insurance undertakings distributing insurance-based investment products are required to obtain information about the customers' suitability for the investment product (e.g. risk appetite, investment experience). Suitability assessments do not generally include questions on sustainability preferences and most customers would not raise the sustainability issue themselves. As a result, insurance intermediaries and insurance undertakings distributing insurance-based investment products consistently do not consider sustainability factors in the selection process and the purpose of the regulation is to address this.
- **Product oversight and governance**: Sustainability risks must be integrated into product oversight and governance requirements and into the rules on conflicts of interest. This is based on technical advice delivered by the EIOPA in April 2019 on

the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD.

In order to mitigate mis-selling risk, firms will need to factor sustainability assessments into their pre-sale disclosures and be pro-active in managing conflicts of interest (e.g. where a policyholder's sustainability preferences conflict with their desire for returns).

In addition, the sustainability assessment requirements which apply to product governance are ongoing obligations. This means that if a policy is sold for the purposes of meeting sustainability criteria and its sustainability rating changes over the lifetime of the product, firms will be expected to withdraw that product from sale and would need to make existing policyholders aware of the change of status.

Solvency II

A draft delegated regulation amends the Solvency II Delegated Regulation.

The amendments to the Solvency II regime focus on sustainability considerations for insurers and reinsurers relating to risk assessment.

The Solvency II draft delegated regulation integrates sustainability factors into insurers' risk management functions and is also largely based on EIOPA's technical advice. It identifies four key areas that will require firms to incorporate sustainability risk into their assessments:

- Risk management framework and risk management functions
- Actuarial assessments of the uncertainty associated with estimates made in the calculation of technical provisions
- Remuneration policy (for consistency with the integration of sustainability risks)
- Implementation of the prudent person principle

The majority of firms will already undertake sustainability assessment as part of their risk framework and investment guidelines. As such, these changes should largely simply formalise existing best practice.

Implementation of sustainability risks into the prudent person principle (and remuneration policy) is less common, however. The EIOPA technical advice confirms that the requirement to assess the impact of investments on sustainability factors is not intended to imply or require compromising on return and profitability of the investments. However, firms will still need to consider sustainability factors when looking at the nature, scale and complexity of their investments.

Next steps

The consultations close on 6 July 2020. The proposed legislation will start to apply one year after their entry into force (i.e., the second half of 2021, assuming they are published during 2020). Managers and insurers will also be dealing with the application of the Disclosure Regulation and the Taxonomy Regulation during 2021 and so should start to prepare for the application of these changes as well.

UK Implementation

Until the end of the Brexit transition period on 31 December 2020, the UK is obliged to transpose EU directives into UK law. However, the implementation deadline for the proposed delegated directives is after the end of the transition period. Similarly, the proposed delegated regulations will not be automatically onshored at the end of the transition period because, although they may well be in force by the end of this year, they will not have become applicable by that date.

It remains to be seen whether the UK Government will take steps to implement similar legislation with a view to remaining in step with the EU's Sustainable Finance Action Plan. The UK Government has previously indicated that it does not intend to diverge from the EU's framework, although in connection with the Taxonomy Regulation, recently reserved judgment on the extent to which the UK will align with the EU after the implementation period. This is because the Taxonomy Regulation delegated legislation contains technical standards that have not yet been published by the European Commission, so the UK does not "have clarity on the final outcome of the file". However, the UK Government has said that it will continue to monitor the legislative process as it considers the UK's approach.

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