



# Sustainable Finance

A Changing Regulatory Framework for Market Players

January 2020



**1**

# **Context & Objectives**



# Global Ambitions for a More Sustainable Finance



## United Nations 2030 Agenda for Sustainable Development



17 SUSTAINABLE DEVELOPMENT GOALS



PRINCIPLES FOR RESPONSIBLE INVESTMENT

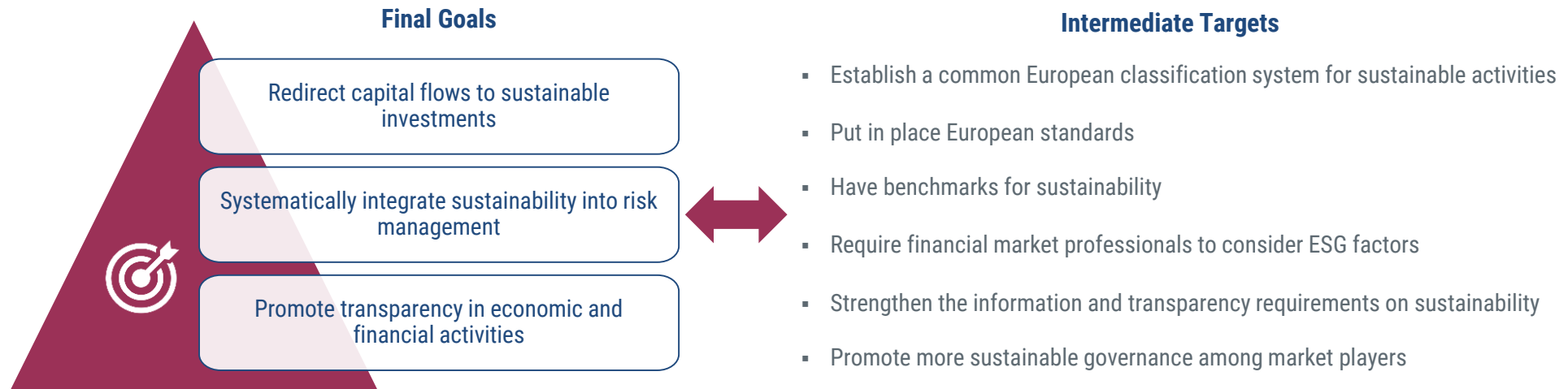
Establishment of a network of international investors working together to put the six Principles for Responsible Investment into practice:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

# The European Regulator Adapts the Regulatory Framework

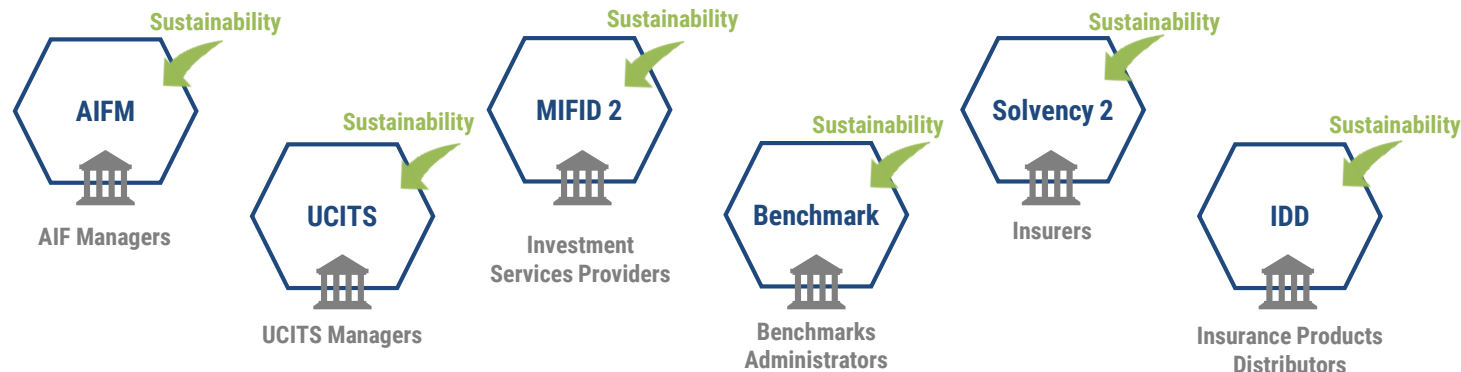


Following the adoption of the 2016 Paris Agreement on Climate Change and the UN 2030 Agenda for Sustainable Development, the European regulator has made sustainable finance one of its priorities and has defined several medium- and long-term objectives

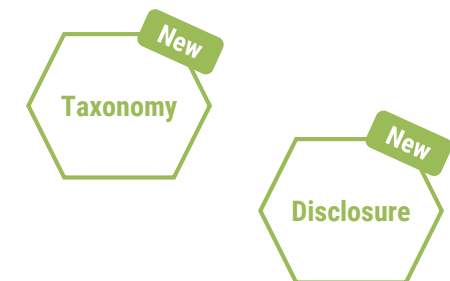


**In order to achieve these objectives, the European regulator is adapting the regulatory framework**

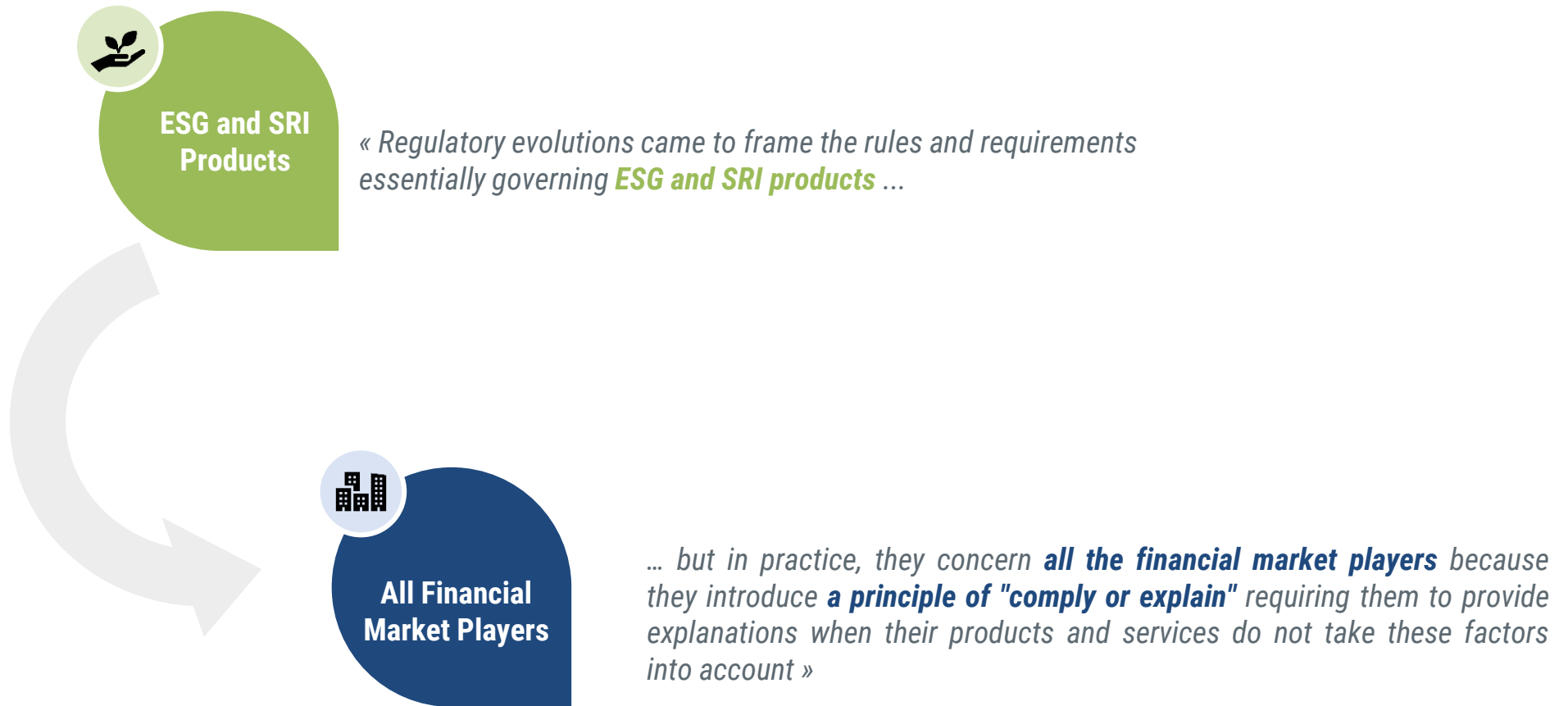
The European regulator **updates all the regulations governing financial activity to accelerate the sustainable transformation of the entire industry**



**Two new transversal regulations setting common definitions and transparency requirements**



# A "Comply or Explain" Approach





The new legislative proposals also seek **to fight greenwashing by enforcing a standardized framework** to prevent products and services from being falsely marketed as sustainable or in favor of the environment



The **Taxonomy regulation** provides criteria and a procedure for identifying sustainable investments, in order to avoid differences in interpretation leading to distortions between countries. This regulation will complement the other European environmental and climate agreements

The **level 2 provisions of the Benchmark and Disclosure regulations** will also specify the technical standards and norms to be applied

**Strong political and economic challenges have slowed the finalization of the Taxonomy Regulation. It is still under discussion, even though the final versions or draft texts of the other regulations have been published**



# Three Axes of Analysis



Regulatory changes introduce **sustainability risk as a new type of investment risk among other risks** (market risk, counterparty risk, liquidity risk, etc.)

*Definition\*:* an environmental, social or governance event or situation which, if it occurs, could have a significant negative effect, real or potential, on the value of the investment

All financial market players and all products are concerned



Regulatory changes impose **transparency** on considering (or not) **the adverse impacts of investments and products on ESG factors**

*Definition:* The risk of investing in an activity having a negative impact from an environmental, social or good governance point of view (non-financial risk)

All investments and products are concerned, on an "Comply or Explain" approach



Regulatory changes define **environmental criteria** and impose **additional transparency on products promoting ESG characteristics** or displaying **a sustainable investment objective**

*Definition of ESG characteristics:* characteristics related to environmental, social or governance issues

*Definition of sustainable investment\*:* Investment in an economic activity that contributes to an environmental or social objective

These criteria and requirements apply to sustainable finance products

Nevertheless, on product governance, the new regulations require distributors to take ESG preferences into account when defining target markets

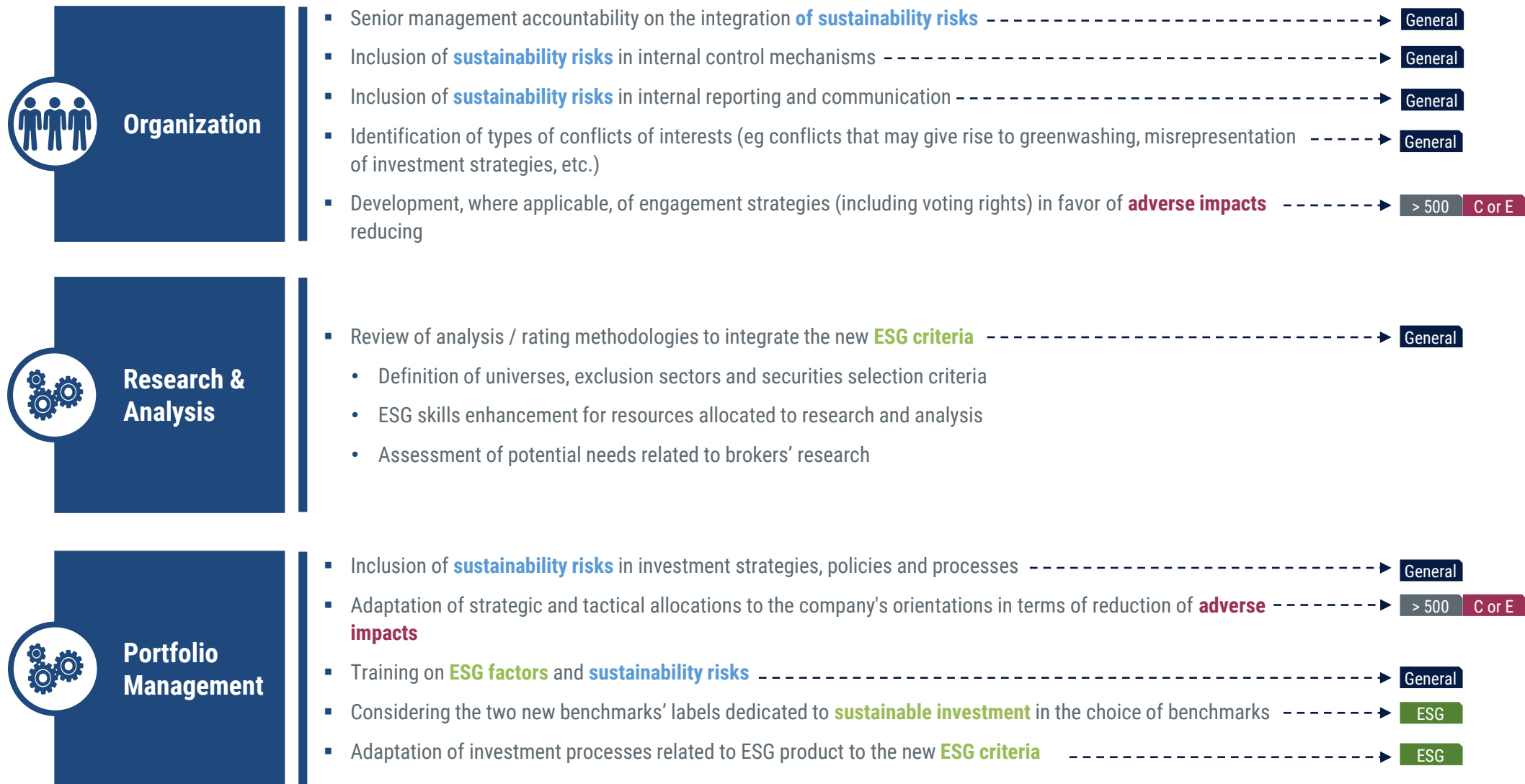
\* Definitions from the Disclosure regulation



## **2** Impacts for Market Players



# Main Impacts for Market Players (1/3)



**XXX:** Impacts related to sustainability risk

**XXX:** Impacts related to considering adverse impacts

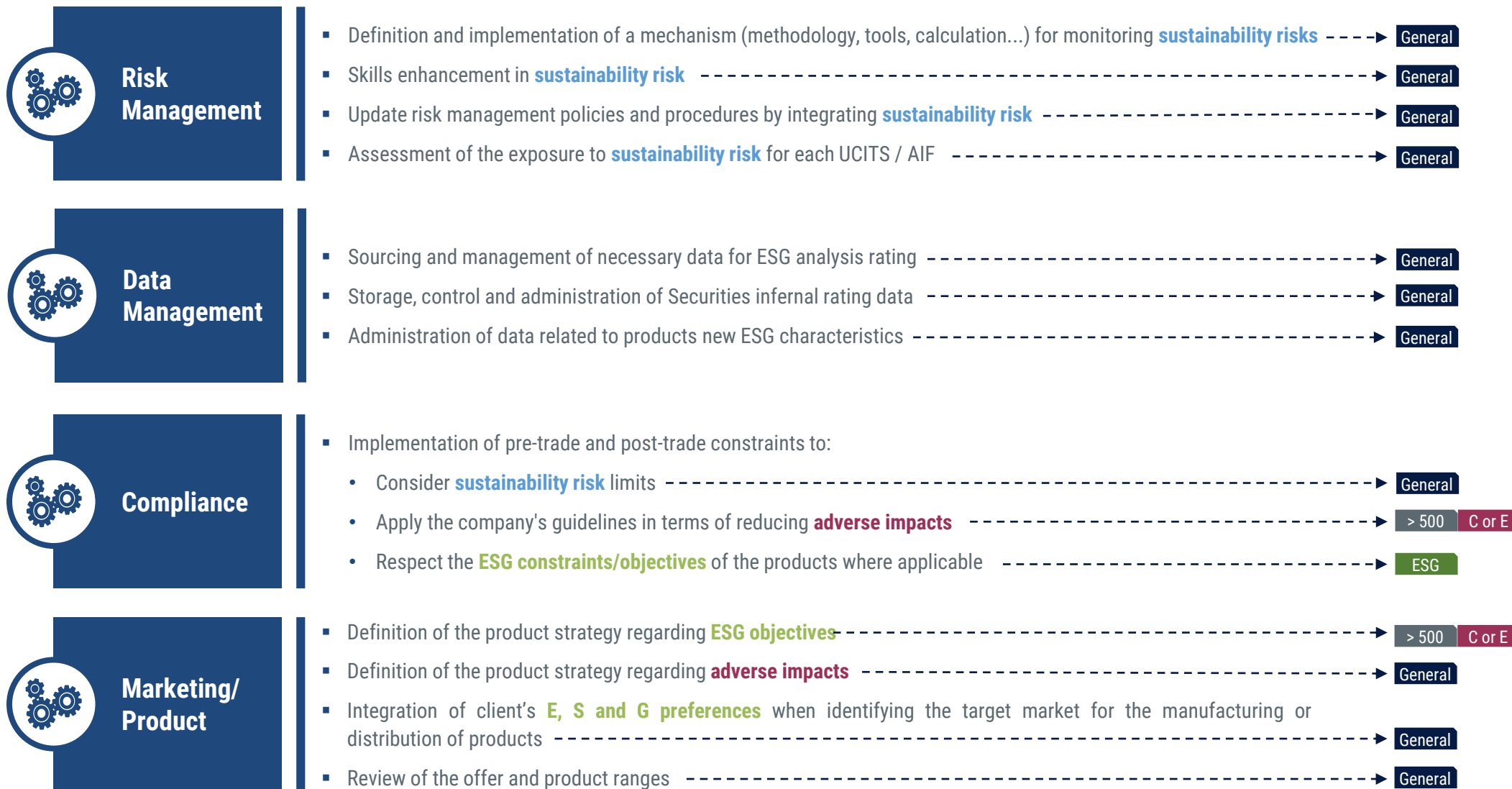
**XXX:** Impacts related to ESG characteristics

**General** Applicable for all products and/or actors

**> 500 C or E** In a « comply or explain » approach, mandatory from 500 employees

**ESG** Sustainable investments or products with environmental or social characteristics

# Main Impacts for Market Players (2/3)



**XXX:** Impacts related to sustainability risk

**XXX:** Impacts related to considering adverse impacts

**XXX:** Impacts related to ESG characteristics

**General** Applicable for all products and/or actors

**> 500 C or E** In a « comply or explain » approach, mandatory from 500 employees

**ESG** Sustainable investments or products with environmental or social characteristics

# Main Impacts for Market Players (3/3)



## Pre-contractual Documents

- Explanation of how **sustainability risks** are integrated in investment decisions -----> **General**
- Result of the assessment of the likely impact of **sustainability risks** on product performance -----> **General**
- Clear and reasoned explanation of how a product considers the main **adverse impacts** on sustainability factors -----> **> 500 C or E**
- Explanation of how **sustainability objectives** are achieved or **ESG characteristics** are met and, if applicable, how the benchmark has been used and is aligned with this objective -----> **ESG**

## Periodic Reports

Periodic reports including the extent to which **ESG characteristics** are respected -----> **ESG**

## Website

- Description for each product its **ESG characteristics** or the **sustainable objective** pursued -----> **ESG**
- Description of the methodology for evaluating and monitoring **ESG characteristics** or the **sustainable objective** pursued -----> **ESG**
- Description at the entity level of:
  - Policies on the integration of **sustainability risks** in investment decisions/advisory -----> **General**
  - Due diligence policies regarding **adverse impacts** on sustainability factors -----> **> 500 C or E**
  - Remuneration policies adapted to the integration of **sustainability risks** -----> **General**

**XXX**: Impacts related to sustainability risk

**XXX**: Impacts related to considering adverse impacts

**XXX**: Impacts related to ESG characteristics

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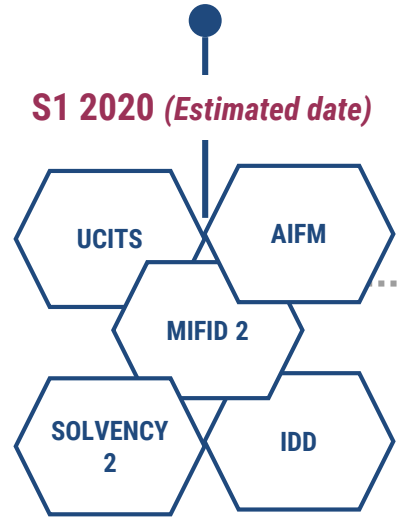


## **3 Focus on Regulatory Evolutions**

# Main Deadlines



Integration of sustainability risks into organizational aspects, investment and risk management policies and procedures, and product governance



**S1 2020 (Estimated date)**

Upgrade of pre-contractual documentation, periodic reports and web displays considering transparency requirements on sustainability risks, adverse impacts on sustainability and ESG criteria

**10/03/2020**



**30/04/2020**

Review of the adequacy of benchmarks regarding the sustainability objectives (ESG or decarbonation) of funds



**31/03/2021**

- Implementation of technical screening criteria related to environmental objectives<sup>1</sup> 1 and 2
- Upgrade of pre-contractual documentation, periodic reports for products promoting or contributing to those objectives

**31/12/2021**



- Implementation of technical screening criteria related to environmental objectives<sup>1</sup> 3 to 4
- Upgrade of pre-contractual documentation, periodic reports for products promoting or contributing to those objectives

(1) Environmental objectives detailed in page 18



Following the European Commission's request, ESMA provided technical advice to integrate sustainability risks and factors in the UCITS Directive, AIFMD and MiFID II

## Organization

- Consider sustainability risks in:
  - Decision-making procedures and the organizational structure
  - Internal control mechanisms
  - Internal reporting and communication
- Devote resources and expertise for the effective integration of sustainability risks
- Ensure that senior management is responsible for the integration of sustainability risks

## Risk Management

- Update risk management policy and procedures to enable the management company to assess, for each UCITS/AIF, the exposure to sustainability risks
- Monitor any third parties performing the risk management activities

## Operating Conditions

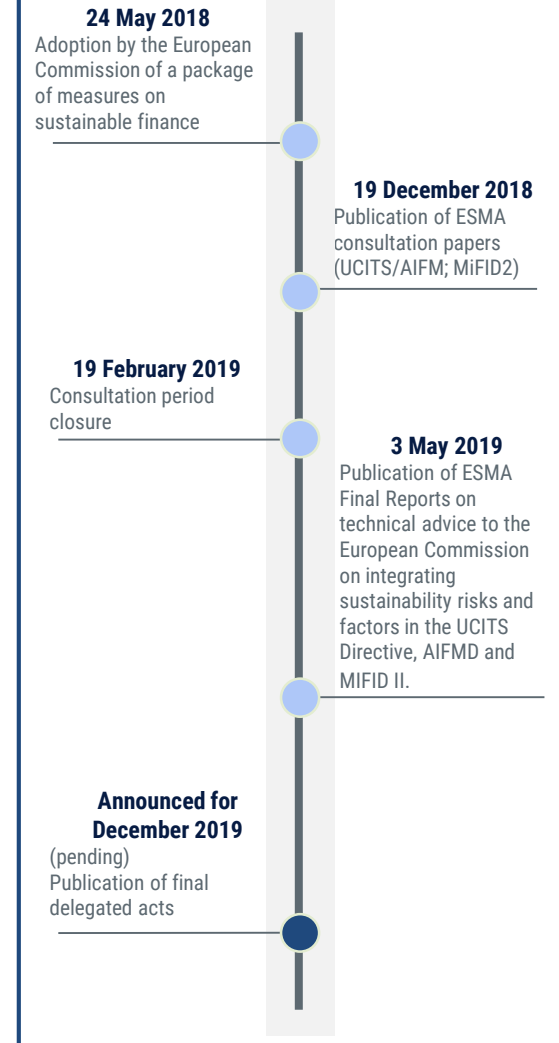
Consider sustainability risks and the principal adverse impact (for concerned players) of investment decisions on sustainability factors in:

- Identifying the types of conflicts of interest (ex: conflicts that could give rise to greenwashing, misrepresentation of investment strategies ...)
- Policies and procedures on due diligences and compliance with the fund objectives, investment strategy and risk limits
- Ensuring the adequate understanding of the invested assets
- The application of a voting policy in favor of sustainability objectives

## Product Governance

- When identifying the potential target market for manufacturing or distributing a financial product, include the ESG preferences of the client and determine whether the financial instrument's ESG characteristics are coherent with the target market

## Timeline

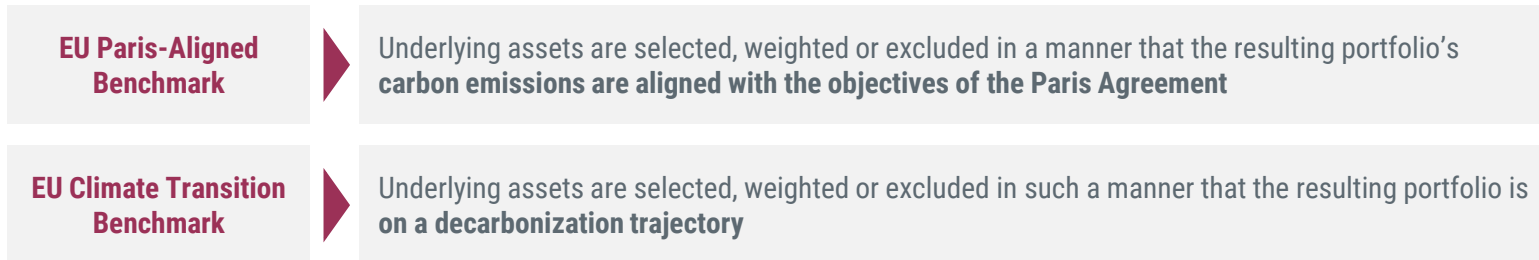






The European Commission intend through this update to provide investors with better information on the carbon footprint of companies and investment portfolios

## Creation of two green benchmark labels



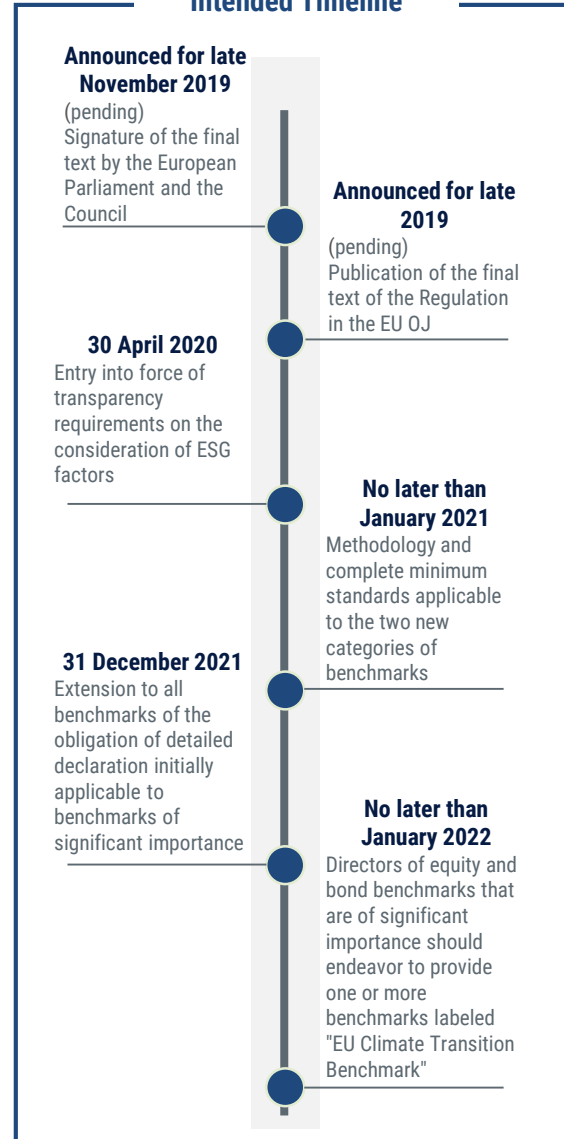
## Transparency on how ESG factors are reflected in benchmarks

*interest rate and exchange rate benchmarks are exempt*

- ➔ All benchmark administrators are required to disclose in their **benchmark statement**:
  - Whether or not their benchmarks or families of benchmarks **pursue ESG objectives**
  - An explanation of how the key elements of the **methodology consider ESG factors**
  
- ➔ Administrators of **equity** and **bond benchmarks** which **are of significant importance** \* as well as administrators of "EU Climate Transition Benchmark" or "EU Paris-Aligned Benchmark" must publish a detailed declaration indicating whether and to what extent an alignment with the decarbonization objective or the objective of limiting global warming of the Paris climate agreement is guaranteed
  - ⚠ **By 12/31/2021, this requirement should apply to all benchmarks**
  - ⚠ **By 01/01/2022, administrators of significant equity and bond benchmarks should endeavor to provide one or more benchmarks labeled "EU Climate Transition Benchmark"**

(\* ) When the benchmark is used directly or indirectly within a combination of benchmarks to determine the price of financial instruments or financial contracts or to measure the performance of certain investment funds, whose aggregate outstanding amounts represent at least 50 Billions of Euro's

## Intended Timeline





Following the request of the European Commission, EIOPA provided technical advice to integrate sustainability risks and factors into the Solvency 2 and IDD directives

## Organization

### Scope: Insurers

- Consider the sustainability risks in governance (Pillar 2 of Solvency 2)
- Integrate sustainability risk management into the scope of the "Risk Management" function
- Integrate sustainability risks into remuneration policies

### Scope: Insurers and Distributors

- When identifying types of conflicts of interest, conflicts of interest which may arise in relation to ESG are to be taken into consideration (e.g. remuneration and incentives to promote the distribution of ESG products that do not correspond to ESG market preferences target)

## Operating Conditions

### Scope: Insurers

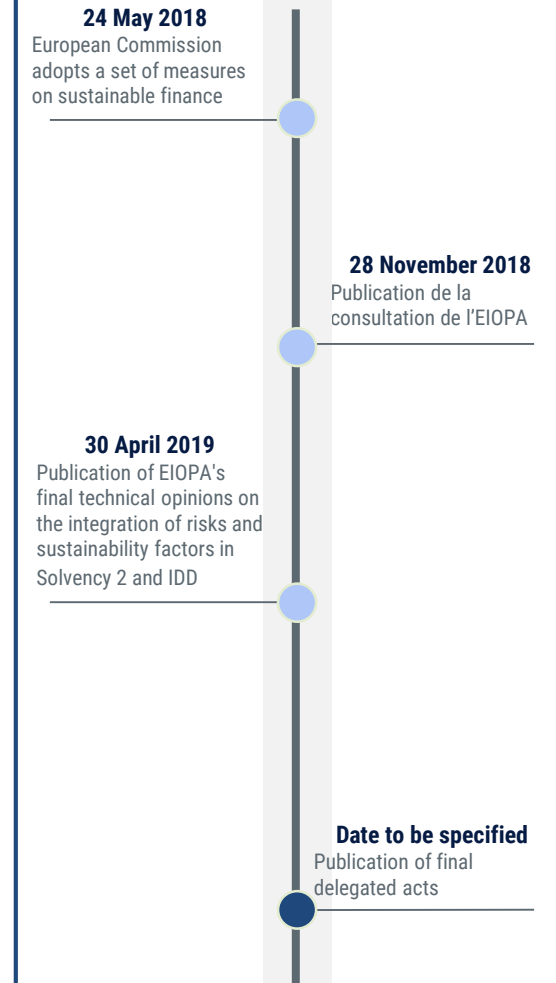
- Integrate sustainability risks into the prudent person principle to take these risks into account when assessing the risk and profitability of a portfolio
- Integrate sustainability risks into the actuarial function. The latter must take them into account when expressing its opinion on the subscription policy

## Product Governance

### Scope: Insurers and Distributors

- When identifying the potential target market for the production or distribution of insurance products, include the client's ESG preferences and determine if the ESG characteristics of the product are consistent with the target market

## Intended Timeline





The regulation establishes the criteria for determining the degree of environmental impact and sustainability of an economic activity for the purposes of establishing the degree of environmental sustainability of an investment

**All financial products are subject to the taxonomy regulation requirements except when stating in the prospectus that the product does not have any significant sustainability impact or that it does not pursue sustainability objectives**

## Criteria for environmentally sustainable economic activities




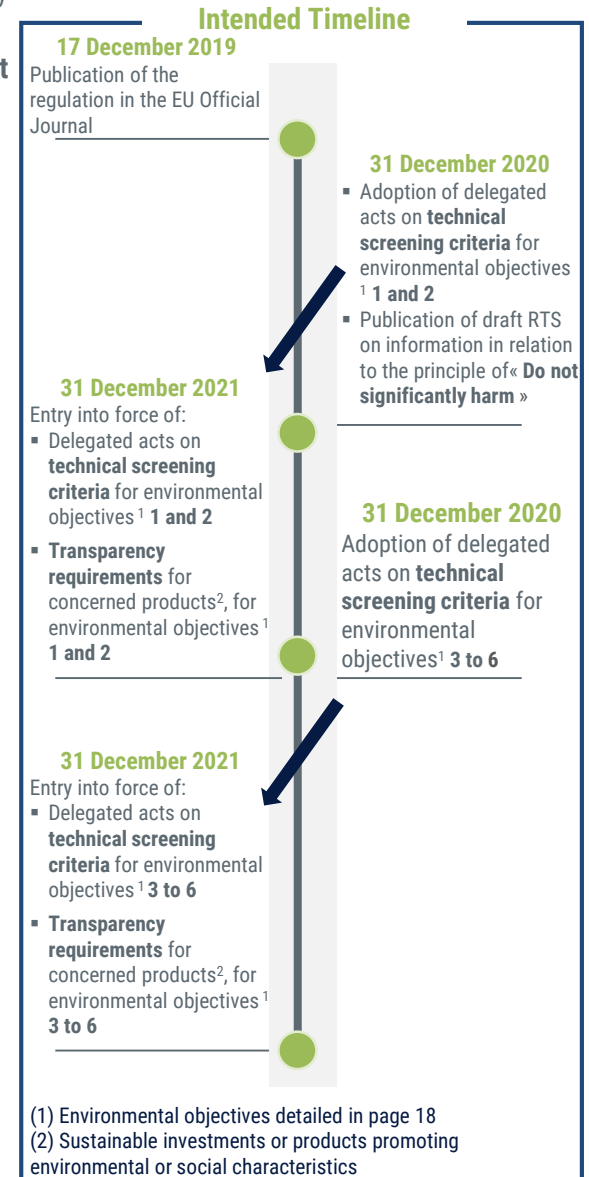
## Disclosure requirements

Obligation to disclose information on **how and to what extent the criteria for environmentally sustainable economic activities are used to determine the environmental sustainability of the investment**. The information shall enable investors to identify:

- The percentage of holdings pertaining to companies carrying out environmentally sustainable economic activities;
- The share of the investment funding environmentally sustainable economic activities as a percentage of all economic activities.

**!** **Financial products promoting only environmental characteristics** (article 8 of Disclosure) must communicate that the « **Do not significantly harm** » principle is applied only to the underlying assets considered to be environmentally sustainable according to Taxonomy. Content, methodology and indicators related to this requirement will be detailed in the Disclosure RTS of Decembre 2020.

 Details on next page







## Details on environmental objectives

### 1 Substantial contribution to one or more of the environmental objectives



1- Climate change mitigation



2- Climate change adaptation



3- Sustainable use and protection of water and marine resources



4- Transition to a circular economy



5- Pollution prevention and control



6- Protection and restoration of biodiversity and ecosystems



## Details on technical screening criteria

4

Compliance technical screening criteria to be specified by the commission

The **technical screening criteria** will specify the minimum requirements that need to be met for each environmental objective. They may be qualitative or quantitative, or both and will cover all relevant economic activities within a specific sector.





The Disclosure Regulation **lays down harmonized rules for the transparency & the provision of information on:**

- Integration of sustainability risks and consideration of adverse sustainability impacts in investment decision-making and in advisory processes
- Sustainable investment and the promotion of environmental or social characteristics

The Energy and Climate Law of 8/11/19 partly anticipated the European regulation and widened its field of application by strengthening the requirements of article 173 on the extra-financial reporting of investors

Level	Information to be published by market professionals	Material
Entity	<ul style="list-style-type: none"> <li>▪ Policies on the integration of sustainability risks in the investment decision-making process or investment advice or insurance advice.</li> <li>▪ Due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors <b>&gt; 500 C or E</b></li> <li>▪ Remuneration policies in relation to the integration of sustainability risks</li> </ul>	Website
All Products	<ul style="list-style-type: none"> <li>▪ The manner in which sustainability risks are integrated into their investment decisions or investment / insurance advice</li> <li>▪ The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available or advise on <b>C or E</b></li> <li>▪ Clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors <b>&gt; 500 C or E</b></li> </ul>	Pre-contractual documents
Financial product with environmental or social characteristics and Sustainable investments	<b>Financial product with environmental or social characteristics</b> <ul style="list-style-type: none"> <li>▪ Information on how environmental or social characteristics are met, if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics</li> </ul>	Pre-contractual documents
	<b>Sustainable investments</b> <ul style="list-style-type: none"> <li>▪ Explain how the sustainability goal is achieved with respect to the “Do Not Significantly Harm” principle. And if a benchmark has been designated, information on how it is aligned with that objective and how it differs from a broad market index</li> </ul>	
	<ul style="list-style-type: none"> <li>▪ A description of the environmental or social characteristics or the sustainable investment objective</li> <li>▪ Methodologies used to assess, measure the characteristics and the objective</li> </ul>	Website
	<ul style="list-style-type: none"> <li>▪ Periodic reports including the extent to which ESG characteristics and the sustainability objectives are met</li> </ul>	Periodic reports

## Intended Timeline



**C or E** Comply or Explain

**> 500** Mandatory if > 500 employees



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## About us

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SAGALINK Consulting is as a leading player in operational strategy and management consultancy for asset management, private banking, insurance, and investor services business. We are known for our strong values and business expertise.

Our expertise in these four interrelated business areas allows us to understand the key challenges across the whole value chain, to identify the best leverages, and to make clear and relevant recommendations. Our culture fosters flexibility and dialogue in order to develop innovative and sustainable business solutions. In the evolving economic and regulatory environment, SAGALINK Consulting helps you to better understand the topics that matter and their impacts on your organization.



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