CLIENT ALERT

EU and UK Regulatory Initiatives Relating to Climate Change Relevant to EU and UK Banks, Insurers and Asset Managers

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Introduction and background

Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the EU has set out in the "Action Plan: Financing Sustainable Growth" its intention to clarify fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities. The initiatives on sustainable finance form part of the EU's broader Capital Markets Union initiative.

The EU has published a large number of legislative proposals aimed at putting environmental, social and governance ("**ESG**") considerations at the heart of the financial system. This briefing reviews recent proposals which focus on the governance arrangements, risk management, disclosure and product governance requirements for EU financial market participants. These show a clear trend in requirements to take account of sustainability risks and factors across the financial sectors.

The regulators' view is that to transition to a non-carbon, more resource efficient and sustainable economy, the financial system must support and finance sustainable growth. The focus of these proposals is on aiding investors understanding of the extent to which sustainability risks and factors are taken account of in investment products and requiring regulated firms to take account of such risks and factors in the management of their organisation and the impact on their business. For some firms, e.g. insurers, they must apply such considerations to both the asset and liability management of their balance sheet. The extent to which any regulatory initiatives do actually lead to increased investment in projects financing the sustainable economy may not be directly quantifiable or correlated.

Regulation on disclosures relating to sustainable investments and sustainability risks ("Disclosure Regulation")[1]

Objective

The aim of the Disclosure Regulation is to require "financial market participants" to integrate ESG considerations into their investment and advisory processes in a consistent manner across sectors to improve disclosures to end-investors.

Scope of application

The Disclosure Regulation defines financial market participants to include:

- UCITs management companies;
- EU alternative investment fund managers;[2]
- insurance companies;
- institutions for occupational retirement provision;
- European venture capital fund managers and European social entrepreneurship fund managers;
- investment firms and banks providing portfolio management and/or investment advice; and
- insurance intermediaries.

A "**sustainable investment**" is defined in the Disclosure Regulation and in summary includes investments in an economic activity that contributes to an environmental objective or a social objective or investments in companies following good governance practices, or a combination of the two. "**Sustainability risk**" is defined to mean an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment arising from an adverse sustainability impact. "**Sustainability factors**" means environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.

1 2018/0179 (COD).

2 This also applies to non-EU AIFMs who have marketed in the EU.

The Disclosure Regulation supplements the disclosure rules that such firms are already subject to under applicable sectoral legislations such as Article 23 of the AIFMD. As the Disclosure Regulation will apply to such a broad range of financial market participants, it will be relevant to a wide range of financial products, e.g. investment funds, life insurance or pension products and portfolio management services.

Information disclosures on websites and in pre-contractual disclosures

Website

Financial market participants will be required to publish on their websites up-to-date:

- information on their policies on the integration of sustainability risks in their investment decision-making process or in the case of financial advisors in respect of their investment advice;
- information on how the target of sustainable investments is ensured;
- a description of the sustainable investments target; and
- information on the methodologies used to assess, evaluate and monitor the effectiveness of the investments.

Specific information requirements relate to firms with more than 500 employees and those that consider "principal adverse impacts of investment decisions on sustainability factors".

Such firms must adhere to responsible business conduct codes and internationally recognised standards for due diligence and reporting. There is no definition yet of "principal adverse impacts"; however, each of the European Supervisory Authorities ("**ESAs**") – EBA, ESMA and EIOPA[3] – are required to develop regulatory technical standards on the content, methodologies and presentation of the information required. So in due course further detail as to the ESAs' expectations will become available.

Firms with less than 500 employees may consider "principal adverse impacts", but if they don't, they shall give reasons for not doing so.

Firms that promote financial products with environmental or social characteristics shall provide information on their websites, including a description of the environmental or social characteristics or the sustainable investment objective of

[3] EBA - European Banking Authority; ESMA - European Securities and Markets Authority; and EIOPA - European Insurance and Occupational Pensions Authority.

those products, information on how those characteristics are met, and information on the methodologies and data sources used to assess, monitor and measure performance.

Pre-contractual disclosure

All financial market participants will need to supplement their current pre-contractual disclosures required by applicable sectoral legislation with those required by the Disclosure Regulation. These include:

- the manner in which sustainability risks are integrated in investment decisions and how such risks are integrated in investment advice and insurance advice;
- the extent to which sustainability risks are expected to have an impact on the returns of the financial products;
- information on how a firm's remuneration policies are consistent with the integration of sustainability risks;
- where sustainability investments are referenced to a benchmark, information as to the appropriateness of the designated benchmark, namely the alignment of that investment with the sustainable investment target; and
- where a financial product targets a reduction in carbon emissions, information requirements relating to the targeted low carbon emission exposure.

If sustainability risks are deemed not relevant this should also be explained. On an ongoing basis periodical reports to investors should include a description of the overall sustainability-related impact by the financial product or, where an index has been designated as a reference benchmark, a comparison between the overall impact of the financial product with that index and a broad market.

It is expected that the Disclosure Regulation, which was agreed in April 2019, will come into effect in November 2019 and shall apply 15 months from that time.

Proposals to integrate sustainability risks and factors into UCITs, AIFMD, MiFID II, Solvency II and the Insurance Distribution Directive[4]

On 30 April, ESMA published its technical advice to the European Commission on integrating sustainability risks and factors with regards to investment firms and fund managers in the Markets in Financial Instruments Directive II, the Alternative Investment Fund Managers Directive and the Undertakings in Collective Investment in Transferable Securities

[4] Final Reports on UCITs, AIFMD, MiFID II, Solvency II and the Insurance Distribution Directive available here, here, and here.

Directive. The final reports were developed in collaboration with EIOPA, which had a similar mandate in respect of insurers regarding Solvency II and the Insurance Distribution Directive ("**IDD**").

The final reports follow a period of consultation and close collaboration between ESMA and EIOPA to ensure consistency across the financial sectors.

ESMA recognises that several EU legislative proposals are still not finalised and that prescriptive requirements in relation to sustainability risks may therefore result in potential regulatory inconsistencies and legal uncertainty. Accordingly, ESMA states that the proposals take a high-level, principle-based approach and bear in mind the proportionality principle. The requirements for and regulation of sustainability will continuously evolve as the EU's initiative develops.

ESMA's aim is that senior management should be collectively responsible for the integration of sustainability risks and that firms should have the skills, knowledge and expertise to manage sustainability risks without the need to designate a specific person as being responsible.

ESMA also acknowledges that the absence of a common methodology to understand what constitutes a sustainable economic activity, for investment purposes, might have an impact on the comparability among financial instruments and reduce possibilities for investors to effectively compare the standards of ESG-related disclosures across different companies or investments.

ESMA and EIOPA noted that the technical advices were published soon after the Disclosure Regulation, which contains definitions of "sustainability risk" and "sustainability factors", so they had not had sufficient time to take those definitions into account. They have indicated that future iterations of these proposals are likely to cross-reference the definitions in the Disclosure Regulation to ensure consistency of interpretation and application.

MiFID II	
Conflicts of interest	Firms to identify conflicts of interest arising from the distribution of sustainable investments and ensure that the inclusion of ESG considerations does not lead to misselling practices.
Organisational/governance	Clarification that MiFID II duties will require firms to assess ESG factors and take them into account when serving their clients.
Product governance	Firms to take account of the ESG preferences of a client where relevant in manufacturing and distributing financial products. ESMA is in the course of updating its guidelines on product governance and suitability assessments.

Risk management	Firms to take account of sustainability risks as part of their risk management policies and procedures.
UCITs / AIFMD	
Conflicts of interest	Managers to identify conflicts that may arise due to the integration of sustainability risks.
Organisational/governance	Managers to take account of sustainability risks in their decision-making procedures and in their systems and controls; have the necessary resources and expertise for the effective integration of sustainability risks; and ensure that senior management is responsible for the integration of sustainability risks.
Due diligence	Managers to take into account sustainability risks and where applicable the principal adverse impact of investment decisions on sustainability factors; and where applicable develop engagement strategies including for the exercise of voting rights with a view to reducing the principal adverse impact of investee companies on sustainability factors.
Solvency II	
Actuarial function	To take account of sustainability risks in relation to the underwriting policy.
Operating conditions	In accordance with the prudent person principle, insurers shall take into account sustainability risks when assessing the security, quality, liquidity and profitability of the portfolio as a whole. This shall include taking into account the potential long-term impact of their investment strategy and decisions on sustainability factors and, where relevant, reflect the ESG preferences of the target market.
Risk management	In assessing and managing the risk of loss or change in values of liabilities, insurers shall consider the impact of sustainability risks. Likewise in managing assets in their investment portfolio, sustainability risks shall be identified, assessed and managed.

Solvency needs	These are to include operational risks, taking into account potential future changes in its risk profile due to the effect of sustainability risks, including climate change, on its business.
IDD	
Conflicts of interest	Insurers and their intermediaries shall take appropriate steps to identify and manage conflicts of interest that may arise in relation to ESG consideration in the course of insurance distribution strategies.
Prudent governance	These include requirements to take account of ESG preferences of customers in designing and distributing insurance products.

EIOPA has noted that without prejudice to the definition of "sustainability risks" in the Disclosure Regulation, it should be understood as risks that could affect the insurers' risk profile, on the investments and liabilities side, due to ESG factors.

UK regulatory initiatives

The UK regulators have produced a number of papers relating to climate change and the implications for financial services. The FCA[5] published a Discussion Paper on Climate Change and Green Finance in October 2018.[6] This paper focuses on different areas of concern such as (i) ensuring that issuers of listed securities meet their disclosure obligations, including disclosures about climate change risks if appropriate, (ii) ensuring regulated firms have adequate controls in place for considering risks, including those from climate change and the transition to a low-carbon economy, and (iii) their role in protecting consumers and market integrity.

The Bank of England's mandate includes responsibility for financial stability. In connection with this, together with the PRA[7] and the FCA in the UK, the UK regulators have established a Climate Financial Risk Forum ("**CFRF**") to share best practices across financial regulators and industry to advance financial sector responses to the financial risks from climate change. The CFRF has senior representatives from banks, insurers and asset managers. The CFRF set up working groups at its first meeting in March 2019 on risk management, scenario analysis, disclosure and innovation.

The PRA has published its supervisory expectations that set out how banks and insurance companies regulated by it need to develop an enhanced approach to managing the financial risks from climate change.[8] The PRA recognises that

5 Financial Conduct Authority.

6 DP18/8.

7 Prudential Regulation Authority.

8 Supervisory Statement SS3/19 April 2019.

as the understanding of climate change risk is not mature, it should not be prescriptive. Nevertheless they have described the type of physical and transition risks that could give rise to financial risks from climate change, and set out their expectations as to the strategic approach to managing such risks. These include commentary as to how firms should:

a) embed the consideration of the financial risks from climate change in their governance arrangements, including identifying a senior manager and ensuring that responsibility for managing and identifying these risks is included in that manager's "Statement of Responsibilities";

b) incorporate the financial risks from climate change into existing financial risk management practice, including any material exposures to such risks and an assessment of how they have been determined for firms' ICAAP or ORSA;[9]

c) use (long-term) scenario analysis to inform strategy setting and risk assessment and identification; firms should use the scenario analysis to inform their solvency, liquidity and ability to pay policy holders; and

d) develop an approach to disclosure on the financial risks from climate change.

This supervisory statement already applies to banks and insurers in the UK.

The PRA published "A framework for assessing financial impacts of physical climate change: A practitioner's aide for the general insurance sector" on 22 May 2019 which insurers are encouraged to read alongside the supervisory statement. The report sets out a proposed framework for assessing financial impacts on an insurer's liabilities from physical climate change risk and the potential impact on business decisions.

The initiatives described in this paper represent only a portion of the initiatives being developed internationally and at the national level. The various proposals have generated a range of industry responses. A common theme has been that there should be further focus on agreed definitions and taxonomy if there is to be an harmonised approach across sectors, and in the case of financial products to allow investors to compare and assess ESG factors in different financial products. The ESAs have acknowledged that any proposed change should be applied by reference to the proportionality principle, i.e. taking into account the size, nature, scale and complexity of a firm's activities. Financial market participants should expect further regulations and proposals as tools, data and expertise in climate change risks and ESG develop, and as market and best practices emerge.

It will be interesting to see how this influences financial firms' risk management and disclosure processes and the provision of financial products focused on ESG.

[9] Internal Capital Adequacy Assessment and Own Risk and Solvency Assessment.

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