Amending Delegated Acts to integrate ESG factors into the MiFID II, IDD, Solvency II, UCITS and AIFMD regulations

European Commission

List of abbreviations

Abbreviation	Meaning
AiFMD	Alternative Investment Fund Managers Directive
EC	European Commission
ESG	Environmental Social and Governance factors
EU	European Union
AIF	Alternative Investment Funds
IDD	Insurance and reinsurance distribution Directive
MiFID	Markets and Financial Instruments Directive
SFDR	Sustainable Finance Disclosure Regulation
UCITS	Undertakings for collective investment in transferable securities Directive

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1 Introduction and regulatory context

In August 2021, the EC adopted six amending Delegated Acts which aim to require financial institutions [(1)] to integrate sustainability factors and risks in their internal procedures and in their investment advice to clients

- **The Paris Agreement**, signed in 2015, aims to reinforce the international response to the threat of climate change and establishes the objective of a maximum temperature increase of 2ºC in the XXI century relative to preindustrial levels. In the same year, all United Nations Member States adopted the **Sustainable Development Agenda for 2030**.
- Following the adoption of the Paris Agreement and the Agenda for 2030, the EC presented in 2018 the **Action Plan on Financing Sustainable Growth**. This plan has three main goals:
  - Reorienting capital flows toward a more sustainable economy.
  - Mainstreaming sustainability in risk management.
  - Fostering transparency and long-termism.
- Taking into account the objective of the Paris Agreement, the EC presented the **European Green Deal** in December 2019, which sets the goal of no net greenhouse gas emissions from 2050. This target requires that clear signals are given to investors with regard to their investments to avoid stranded assets and to raise sustainable finance.

- In this context, financial institutions need to **integrate sustainability factors and risks into their internal procedures, investment management and their investment advice to clients**.
- To this end, the EC published in April 2021 the proposed amendment of six Delegated Acts to integrate ESG factors into the MiFID II, IDD, Solvency II, UCITS and AIFMD regulations. These Delegated Acts introduce important amendments to these regulations. In August 2021, the Delegated Acts were adopted by the EP and Council and entered into force on 2 September 2021.
- These amendments apply from **2 August 2022**, except for the amendments to Delegated Directive 2017/593 on product governance obligations of investment firms, which will apply from **22 November 2022**.

(1) Particularly, institutions that offer or distribute investment advisory services, asset management or insurances.

2 | General view of the amendments

In August 2021, six delegated acts amending MIFID II, IDD, UCITS, AIFM and Solvency II were adopted to require financial institutions to integrate sustainability factors and risks into their internal procedures and into their investment advice to customers

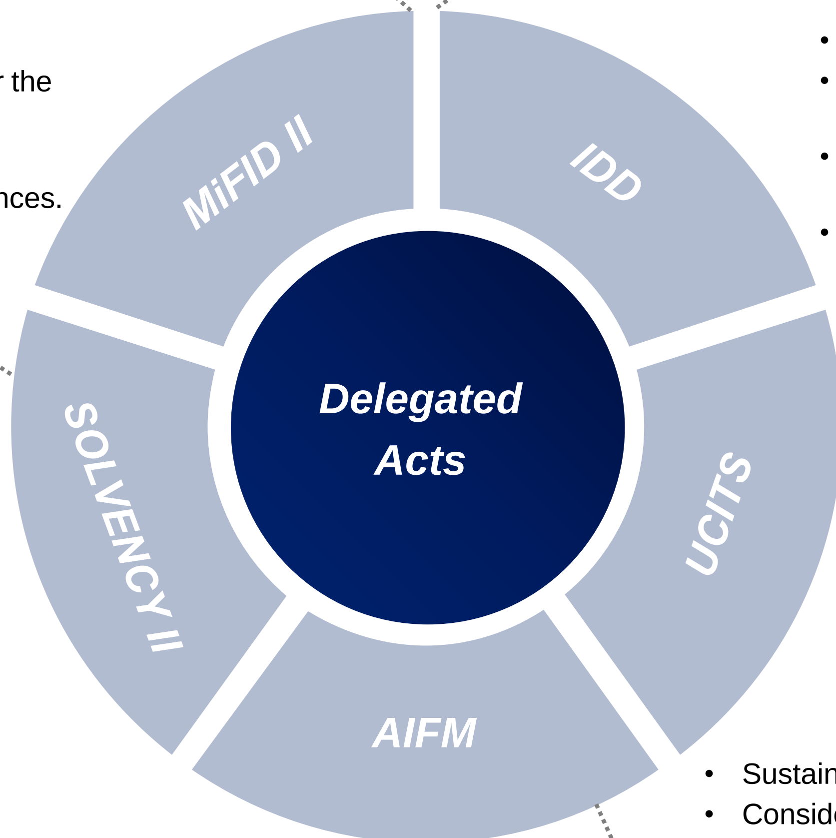
Executive Summary

MiFID II

- Sustainability-related objectives.
- Adequacy of financial instruments for the target market.
- Transparent disclosure.
- Assessment of sustainability preferences.
- Reports, policies and procedures.

IDD

- Sustainability-related objectives.
- Transparent disclosure of sustainability factors.
- Conflicts of interest taking into account sustainability factors.
- Assessment of sustainability preferences.



Solvency II

- Sustainability definitions.
- Sustainability risks in the calculation of technical provisions.
- Compensation policy.
- Integration of sustainability risks in investment appraisal and management of sustainability risks.

UCITS

- Sustainability definitions.
- Resources and experience in sustainability risk integration.
- Consideration of adverse events.
- Risk management policy.

AIFM

- Sustainability definitions.
- Consideration of adverse events.
- Conflicts of interest and policies.

2 | MiFID II
Del. Directive 2021/1269 which amends Del. Directive 2017/593

Investment firms should considered sustainability factors, and sustainability-related objectives in relation to product governance and oversight arrangements of their products and services

Context

- The EC Delegated Directive (EU) 2017/593 supplements Directive 2014/65/EU of the EP and the Council (MiFID II) by specifiying obligations on product and services governance.

Aspects to be considered:

Definitions

- Includes the definition:
  - **Sustainability factors**: mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters

Target Market

- Investment firms are required to identify groups of clients with whose needs, characteristics and objectives are compatible with the financial instrument. In this process of identifying the **target market**, **sustainability factors must be taken into account**..

Product governance

- Sustainability factors are integrated into **product governance arrangements** to ensure that products are fit for purpose. Sustainability factors are also integrated into the **periodic review** process of products or services.

Transparency

- Sustainability factors of financial instruments should be disclosed in a **transparent manner that allows investment firms to engage in a dialogue with clients or potential clients** and thus have a sufficiently detailed understanding of their preferences.

2 | MiFID II
Del. Regulation 2021/1253 which amends Del. Regulation 2017/565

The amendments to this Regulation introduce the financial objectives and posible sustainability preferences that clientes may express in terms of investment and portfolio management

Context

- The EC Delegated Regulation (EU) 2017/565 supplements MiFID II as regards organisational requirements and operating conditions for investment firms.

Aspects to be considered:

Definitions

- It introduces the following defintions:
  - **Sustainability preferences**: a client's decision whether or not to integrate in their investment one or more financial instruments that meet certain sustainability characteristics. This means that a proportion of the instrument is invested in sustainable activities in accordance with the taxonomy and SFDR, or that the financial instrument considers the main adverse impacts on sustainability factors.
  - **Sustainability factors**: mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
  - **Sustainability risks**: means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Governance and risk management

- **Sustainability risks** must be considered in meeting organisational requirements (e.g. decision-making, organisational structure and internal control mechanisms), as well as in the establishment, implementation and maintenance of risk policies and procedures, and in the established tolerance levels

Conflicts of interest

- Investment firms, when identifying the types of conflicts of interest whose existence may damage the interests of a client or potential client, should include those types of conflicts of interest **that stem from the integration of the client's sustainability preferences**. .

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Del. Regulation 2021/1255 which amends Del. Regulation 231/2013

This Regulation incorporates a number of amendments that clarify the current obligation for AIFMs to integrate sustainability risks

Context

- The EC Delegated Regulation (EU) 231/2013 supplements Directive 2011/61/EU on AIFMS and specifies the operating conditions, including rules on due diligence or identification of types of conflicts of interest relevant to AIFMs.

Aspects to be considered:

Definitions

- It introduces the following definitions:
  - **Sustainability factors**: mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
  - **Sustainability risks**: means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Due Diligence

- **Sustainability risks** should be considered in the due diligence of investment selection and monitoring (due diligence policies and procedures take these risks into account).

Experience, conflicts of interest and management policy

- AIFMs should have personnel with the necessary **knowledge and experience** to perform the functions assigned to them and to be able to integrate sustainability risks.
- In determining the types of **conflicts of interest** that arise in the course of managing an AIF, AIFMs should ensure that they include those types of conflicts of interest that may arise as a result of the integration of sustainability risks into their processes, systems and internal controls.
- The **risk management policy** should include the exposure of AIFMs to sustainability risks.

2 UCITS

Del. Directive 2021/1270 which amends Del. Directive 2010/43

This Directive introduces a series of amendments that clarify the requirements that UCITS must meet regarding the integration of sustainability risks and sustainability factors

Context

- The EC Directive 2010/43/EU specifies organizational requirements, types of conflicts of interest, conduct of business and risk management for UCITS management companies.

Aspects to be considered:

Definitions

- It introduces the following definitions:
  - **Sustainability factors:** mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
  - **Sustainability risk:** means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Expertise, Policies and Conflicts of Interest

- The personnel of UCITS management companies should have the necessary **qualifications, knowledge and expertise** to carry out the responsibilities assigned to them and to integrate **sustainability risks** effectively. In addition, the senior management should integrate **sustainability risks** into the upcoming **overall investment policy** and in the periodic review of the **risk management policy**.
- When determining the types of **conflicts of interest** that may harm the interests of UCITS, management companies should include conflicts that may arise as a result of the integration of sustainability risks.

2 | Solvency II

Del. Regulation 2021/1256 which amends Del. Regulation 2015/35

This Regulation incorporates a series of amendments that clarify that the system of governance of insurance and reinsurance undertakings and the assessment of their overall solvency needs must reflect sustainability risks

Context

- The EC Delegated Regulation (EU) 2015/35 specifies governance, conflicts of interest and risk management requirements applicable to insurance and reinsurance undertakings..

Aspects to be considered:

Definitions

- It introduces the following definitions:
  - **Sustainability risk:** means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.
  - **Sustainability factors:** mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
  - **Sustainability preferences:** a client's decision whether or not to integrate in their investment one or more financial instruments that meet certain sustainability characteristics. This means that a proportion of the instrument is invested in sustainable activities in accordance with the taxonomy and SFDR, or that the financial instrument considers the main adverse impacts on sustainability factors.

Management integration

- The actuarial function of insurance and reinsurance undertakings must take sustainability risks into account in its assessment of the uncertainty associated with the estimates made when calculating **technical provisions.** In addition, sustainability risks are integrated as factors in determining **underwriting and provisioning policies and constitution of reserves.** As well as in the management of assets and liabilities. Sustainability risks must be considered when **identifying, measuring, monitoring, managing, controlling, reporting and evaluating risks arising from investments**. The **remuneration policy** shall include information on how it takes into account the integration of sustainability risks in the risk management system.

D. Reg. 2021/1257 which amends D. Regs. 2017/2358 and 2017/2359

The amendments to these Delegated Regulations integrate customer preferences in terms of sustainability as a complement to the suitability assessment. They also incorporate sustainability risks into product oversight and governance requirements and conflict of interest rules

Context

- The EC Delegated Regulation (EU) 2017/2358 supplements Directive (EU) 2016/97 on insurance distribution by further specifying the product control and governance requirements applicable to insurance undertakings and insurance distributors. EC Delegated Regulation (EU) 2017/2359 also supplements this Directive by specifying the information requirements and rules on conduct of business applicable to the distribution of insurance-based investment products.

Aspects to be considered:

Amendments to Regulation 2017/2358

- Insurance undertakings and insurance intermediaries that produce insurance products (producers) should consider **customers' sustainability objectives** when designing a product.
- Producers should define the target market for a product based on the characteristics, risk profile, complexity and nature of the insurance product, as well as its sustainability factors. These factors should also be integrated into the **periodic review** process of insurance products. In addition, product distribution should ensure that the objectives, interests and characteristics of clients, including any sustainability objectives, are duly taken into account.

Amendments to Regulation 2017/2359

- Introduces the definitions of **sustainability preferences** and **sustainability factors**.
- Insurance intermediaries and insurance undertakings, when identifying the types of conflicts of interest whose existence may undermine the interests of a client or potential client, should include those types of **conflicts of interest that arise from the integration of the client's sustainability preferences**.
- Sustainability preferences are incorporated into the **product suitability and appropriateness analysis**.

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3 | Potential areas of collaboration

Compliance with the amendments to the Delegated Acts on sustainability has implications for governance, policies and procedures, risk management, reporting and systems. Management Solutions has proven experience in all these areas

	Governance, policies and procedures	Management integration / Methodology	Reporting
General	• Global PMO, identification of requirements and information gaps		
	• Training and selection of certifications. • Rev. of governance and functions	• Integration in processes, systems and controls	• Information to stakeholders
Specific requirements: **Investment services companies**	• Evolution of governance mechanisms and periodic product reviews	• Updating customer questionnaires • Definition of appetite / tolerance levels	• Information to clients and potential clients
Specific requirements: **AIFM**	• Due diligence policy • Conflict of interests policy • Risk management policy		
Specific requirements: **UCITS**	• General investments policy • Risk management policy • Conflict of interests policy		
Specific requirements: **Insurers**	• Subscription and constitution of reserves policy • Compensation policy • Evolution of suitability analysis, governance and periodic review of products • Conflict of interests policy	• Calculation of technical provisions • Evaluation of the sustainability ratio of investments	• Information to clients and potential clients

Why Management Solutions?

Areas of collaboration in financial institutions

MS has an expert working group that supports its clients in the development and implementation of the sustainability and climate risk management framework, with a top-down approach in each of the 6 defined lines of action

Areas of collaboration in the field of sustainability and climate change

1 Strategy, Governance and Culture

- Diagnosis, strategic framework and general action plan
- Change management
  - Governance (PMO)
  - Observatory (Regulación / Mercado)
  - Training

2 Self-assessment of sustainability

- Adaptation and gap analysis to regulatory requirements.
- Definition of regulatory and internal taxonomy: eligibility criteria and definition of certification processes.
- Taxonomy implementation: inputs, drivers and outputs.
- Equator Principles v4 implementation.

3 Sustainable business development

- Market diagnosis and analysis (depending on the business, including market research, SWOT analysis, etc.).
- Product/service definition (sprints)
- Launch and implementation

4 Risk Management

- Risk policies and frameworks
- Measurement methodologies (portfolio screening, impact assessment (transitional and physical scenarios) and alignment
- Integration of ESG principles in admission model
- Integration in management (Appetite, Rating, Collateral, Pricing).

5 Data & Tecnology

- ESG model definition and requirements (conceptual, logical and physical)
- Definition of metrics model and KPIs gap analysis
- Definition of functional and technological architecture
- Alternatives Analysis (Vendors/in house)
- Implementation

6 Reporting

- Implementation of requirements (NFRD Supplement, SRDR, ECB Guidelines, Taxonomy, EBA Guidelines...) + (benchmarking of best practices of peers)
- Definition of contents
- Governance and mechanisms for information quality and consistency

Business

- *Retail*
- *Consumer*
- *wholesale and markets*
- *Asset Management*
- *Insurance*

4 Why Management Solutions?
Experience and capabilities

MS has proven experience in the field of sustainability and climate change risks in the financial sector, including specifically the framework for measuring and controlling climate risk

Capabilities in the area of sustainability and climate change

1. **Extensive experience in the field of sustainability and climate and environmental risk management in leading financial groups and entities both in Spain and internationally.**
2. **Multidisciplinary capabilities in the field of sustainability (taxonomy, information and reporting, policies, appetite, admission and follow-up processes...); strong expertise in monitoring and expert analysis of sustainability and sustainable finance regulation at European and international level (EC publications, ECB/EBA and other regulators, ICMA, FSB,...); knowledge of the Climate Stress Test exercise and analysis of the requirements and identification of the impacts on the organization, processes and systems; action plan to adapt to the regulatory requirements.**
3. **Reference consultant for IFC World Bank in the delivery of training activities for financial institutions in the field of Climate Change Risk Management.**
4. **R&D team specialized in the definition and implementation of methodologies for climate risk measurement and analysis of physical and transition risk scenarios (in banking, energy sector and others), portfolio alignment, measurement of the Social Impact of projects (Next Gen context).**
5. **Sponsors and collaborators in the Social Impact Chair of ICADE (Universidad Pontificia Comillas) in the specific field of Social Impact Measurement methodologies.**
6. **Proven experience in supervisory exercises and adaptation of European and American regulatory standards, collaborating with leading financial institutions and supervisors (top-rated consultant by the European Central Bank).**
7. **MS operates as a "one firm", which allows it to have centralized management over projects with local execution as needed, unlike other professional services firms that operate in franchise mode, under the same name but in an unstructured and geographically independent manner.**