30 July 2021

Annex - SFDR Requirements and Applicability

The sub-sections that follow seek to guide on the interpretation of the relevant requirements of the Regulation by the subject entities. This is to be used as a guiding note by FMPs and FAs in filling up the Request for Information.

1. Insurance & Pensions Sector Perspective

Insurers can leave a positive impact on the environment when they invest in products that take account of measures that mitigate problems caused by climate change, which is referred to as 'impact underwriting'. Notwithstanding the challenging nature of such a task, the insurance community is urged to take a more proactive approach to build further resilience against climate change. It is to be noted that as climate change risks increase, premiums will increase, and the industry can be destabilised.

2. Investment Services Sector

In order to fulfil the applicable requirements of the Regulation, investment firms may need to adjust their internal processes, controls, policies and procedures to consider, amongst other matters, the manner in which to:

a) mitigate any potential conflicts of interests that may arise from the manufacturing and distribution of sustainable investments (for instance, remuneration policies structure);
b) integrate sustainability risks and factors into the investment firms' organisational requirements, investment decisions and investment advice, in the context of manufacturing and design, distribution and marketing of relevant products;
c) integrate sustainability risks and factors in the investment firms' product approval and governance processes to consider sustainability preferences, in particular when undertaking target market assessments;
d) update client on-boarding and include sustainability preferences in the provision of investment advice and client suitability assessments (for instance, updating questionnaires to include questions on clients' sustainability preferences, as well as selection process for selection of products portfolio to be offered); and
e) make relevant disclosures to clients (relevant pre-contractual and periodic disclosures in terms of the SFDR, as well as to how products offered meet/continue to meet sustainable preferences).

3. Assessment and Applicability

Since the investment decisions and advice might cause, contribute to or be directly linked to effects on sustainability factors that are negative, material or likely to be material, the entities are required to undergo an assessment of the applicability of the relevant SFDR provisions depending on, inter alia, entity structure and size, business model, products and services provided, etc.

In respect of the financial product, where the sustainability risk assessment leads to the conclusion that there are no sustainability risks deemed to be relevant to the financial product, the reasons therefor should be explained. Where the assessment leads to the conclusion that those risks are relevant, the extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms. The sustainability risk assessments and related pre-contractual disclosures by financial market participants should feed into pre-contractual disclosures by financial advisers.

4. Products

FMPs and FAs are required to conduct an assessment of their products with a view to classify them as:

a) Light Green which are financial products with environmental or social characteristics in terms of Article 8 of the SFDR;
b) Dark Green which includes financial products with an intended sustainability impact in terms of Article 9 of the SFDR; or
c) Other financial products which cannot be classified as Light Green or Dark Green.

In order to assess whether the financial products under management fall under the above categories, FMPs and FAs may wish to refer to the relevant provisions of the Taxonomy Regulation (EU) 2020/852.

5. Governance

From an insurance sector perspective, the Board of Directors is required to ensure that there is:

a) an adequate management of ESG risks such as climate-related and broader environmental risks;
b) a risk management function which considers ESG risks when implementing risk policies;
c) control of the risk management framework also extends to ESG risks;
d) an incorporation of ESG risks as drivers of financial risks, in particular risks to capital and risks to liquidity and funding. The assessment of these ESG risks should progressively and proportionally be incorporated into the solvency capital requirement assessment;
e) an internal audit function able to include ESG risks in its review of the effectiveness and adequacy of the internal governance arrangements; and
f) awareness, induction, training and expertise, where needed, to identify, assess and manage ESG risks at all levels of the insurance undertaking.

In this respect, insurance undertakings should focus on developing a sustainability strategy and carrying out a carbon footprint assessment in order to assess any gaps in the context of ESG considerations. A copy of such document should be made available if the Authority requests it.

From an investment services perspective, it is expected that investment firms incorporate ESG risks into their business strategies and processes, internal governance structure and arrangements as well as risk management frameworks. The impacts of ESG risks should be appropriately taken into account to ensure the resilience of the firms' business models over the short-, medium- and long-term time horizons.

Similarly, sustainability risks shall be taken into account when establishing, implementing and maintaining internal controls, or setting the firm's level of risk tolerance and establishing, implementing and maintaining adequate risk management policies.

Firms need to establish clear procedures and responsibilities for business lines, internal control functions, the relevant committee(s) and the management body, for the purposes of ensuring a sound and comprehensive approach to the incorporation of ESG risks into business strategy, business processes and risk management.

The Board of Directors should set its 'tone from the top' and be the driver of transformation ensuring:

- the allocation of tasks and responsibilities related to ESG risks and consideration of such risks in the decision-making process;
- ensuring the presence of adequate internal capabilities and arrangements for an effective management of ESG risks; and
- implementing remuneration policies that are aligned with the firms' long-term interests, business strategy and objectives.

6. Website

FMPs and FAs are required to have a live website which is easily accessible by the public, on which they can make the necessary disclosures in terms of the relevant Articles of the SFDR. FMPs and FAs are also invited to refer to the content, methodologies and presentation of disclosures as explained in the final report issued by the European Supervisory Authorities on 2 February 2021 referring to Regulatory Technical Standards.

In terms of Article 4 (1) of the SFDR, FMPs are required to publish and maintain on their website:

a) when FMPs consider principal adverse impacts – the description of such principal adverse impacts and the information on procedures for considering the principal adverse impacts alongside the relevant financial risks and relevant sustainability risks; or
b) if FMPs do not consider principal adverse impacts of investment decisions on sustainability factors - clear reasons why these have not been taken into account, as well as an indication on whether and when they intend to consider such adverse impacts.

In terms of Article 4 (5) of the SFDR, FAs are required to publish and maintain on their website:

a) information as to whether, taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider in their investment advice or insurance advice the principal adverse impacts on sustainability factors; or
b) if they do not consider principal adverse impacts of investment decisions on sustainability factors in their investment advice or insurance advice, as well as an indication on whether and when they intend to consider such adverse impacts.

The website is to include a statement that provides adequate information on the FA's size, scale and products that justifies whether they include adverse impacts on sustainability in their advice.

Whilst the Authority acknowledges that the Final RTSs in terms of Article 4 of the SFDR in relation to the contents and presentation of such statements have not yet been published, it is expected that until such time as these RTSs are finalised the relevant statements are presented in accordance with the latest drafts of these RTSs. In this respect, the European Supervisory Authorities (ESAs) have developed through the Joint Committee a Final Report on the draft Regulatory Technical Standards which can be accessed here.

For each financial product, the relevant website page is to include:

- the ESG characteristics or sustainable objectives; and
- how these characteristics are assessed, measured and monitored.

The information is to be prominent, easily accessible and understandable to retail investors or the relevant target market. It is expected that the published information is in line with the RTSs.

FMPs and FAs shall ensure that their marketing communications do not contradict the information disclosed as per the requirements of the SFDR. The MFSA also expects the compliance officer of an FMPs and FAs to vet and approve all marketing communication where information regarding sustainability may be included and a log of such is to be kept and updated for each marketing communication issued.

Any changes to the sustainability risk policies and remuneration policies relating to the integration of sustainability risk and transparency of the promotion of environmental or social features and sustainable investments on websites should be clearly stated on the website. FMPs and FAs are required to ensure that there is a section on the website that states whether any changes have been made.

7. Remuneration Policies

In the context of designing their environmental, social and governance risk strategy, FMPs and FAs are required to evaluate how to account for their environmental, social and governance risks in their remuneration policies.

Aligning the remuneration policy with the FMPs' and FAs' ESG objectives, is important to avoid conflicts of interest when business decisions are taken. Examples of the manner in which remuneration policies can be aligned with ESG objectives are by amending the long-term resilience of the business strategy under ESG considerations and risk appetite.

Indeed, remuneration policies that give the right incentives to staff members to favour decisions in line with the FMPs and FAs ESG risk-related strategy would facilitate the implementation of ESG risk-related objectives and/or limits, as the staff members would benefit from meeting these (long-term) targets. The impact of remuneration policies on the achievement of sound and effective long-term risk management objectives from the point of view of ESG considerations may be especially relevant when it comes to the variable remuneration of staff whose professional activities have a material impact on the risk of the institution, and in particular when they have responsibilities for defining and implementing ESG-related strategy. Finally, it is to be noted that once remuneration policies are amended, FMPs and FAs are required to publish their remuneration policy on their website.

8. Distribution

FAs are expected to identify which, if any, of the products they distribute, carry an ESG element. FAs are also expected to clearly explain and SFDR related disclosures to clients prior to the finalisation of the sale of the product in question and to retain evidence that the relevant pre-contractual disclosures have been provided to clients in the form prescribed by RTSs, once these are published.

9. Delegated Acts on Sustainability Risks and Factors

i. Amendments to Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359

The European Commission will be amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 regarding the integration of sustainability factors, risks and preferences into the product oversight and governance (POG) requirements for insurance undertakings and distributors and also into the rules on conduct of business and investment advice (suitability assessment) for insurance-based investment products.

The above amendments shall specify that:

a) insurance undertakings and distributors should take into account sustainability factors and sustainability-related objectives in their POG process, in particular in the identification of a target market for insurance products. Furthermore, insurance undertakings and manufacturers are to consider sustainability factors in the product approval process of each product and other POG arrangements for each product that is intended to be distributed to customers seeking sustainability-related insurance products.
b) customers' preferences with regards to sustainability are to now be integrated in the relative suitability assessment, when advice is being provided in the context of the sale of insurance passed investment products. Insurance Based Investment Products that possess some level of sustainability-related materiality are eligible for recommendation to customers who express sustainability preferences and hence intermediaries or undertakings should be able to ask questions to identify their customers' sustainability preferences. When an IBIP does not meet a customers' sustainability preferences, the customer should have the possibility to change the information they provide with respect to their sustainability preferences while the distributor is to maintain records of such decisions. Where a suitability assessment has already been undertaken, the insurance undertaking should have the possibility to identify a customer's sustainability preferences at the next regular update of the suitability assessment.

Further to the above, FMPs and FAs are to advise the Authority what steps are they taking to prepare for their compliance with the above requirements especially in the context of amendments of their product approval process and/or their product distribution arrangements and their internal procedures.

ii. Amendments to Delegated Regulations (EU) 2015/35

The amendments will be introducing new definitions to the Delegated Regulation (EU) 2015/35 on "sustainability risk", "sustainability factors", and "sustainability preferences". The amendments will require that when underwriting and reserving, insurance and reinsurance undertakings are required to assess and manage the risk of loss or of adverse change in the values of insurance and reinsurance

liabilities, resulting from inadequate pricing and provisioning assumptions due to internal or external factors, including sustainability risks. Furthermore, on investment risk management, the insurance and reinsurance undertaking is required to take actions to ensure that sustainability risks relating to the investment portfolio are properly identified, assessed and managed. Insurance and reinsurance undertakings are also required to integrate the points identified above in their policies.

The risk management function of insurance and reinsurance undertakings needs to identify and assess emerging risks and sustainability risks. Furthermore, these risks will also form part of the risks the undertaking is or could be exposed to, taking into account potential future changes in its risk profile, due to the undertaking's business strategy or the economic and financial environment, including operational risks.

With respect to the underwriting policy, the opinion to be expressed by the actuarial function shall include conclusions on the effect of inflation, legal risk, sustainability risks, change in the composition of the undertaking's portfolio, and of systems which adjust the premiums policy-holders pay upwards or downwards depending on their claims history (bonus-malus systems) or similar systems, implemented in specific homogeneous risk groups. Furthermore, the remuneration policy shall also include information on how it takes into account the integration of sustainability risks in the risk management system.

Finally, the Delegated Act will also include a new article 275a on investments and the integration of sustainability risks in the prudent person principle.

iii. Draft Amendments to Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations

These amendments aim to ensure that sustainability factors and sustainability related objectives are adequately considered within the product governance requirements. Sustainability related objectives need to be considered in the target market assessment and cover the financial instrument's objective of sustainable investments or environmental or social characteristics in the product's risk/reward profile and product features.

Moreover, sustainability factors of the financial instruments are to be presented in a transparent manner to facilitate distribution and enable a sufficiently granular understanding of the clients' individual sustainability preferences.

iv. Draft Amendments to Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

The European Commission will be modifying Delegation Regulation (EU) 2017/565 in the following manner:

- Investment firms will be required to obtain information from a client about their sustainability preferences so that when providing advisory or portfolio management services, there is reasonable basis for concluding that investments recommended or made comply with those preferences;
- Clients' investment objectives will have to include their sustainability preferences, if any;

- Investment Firms will be expected to have adequate policies and procedures in place to ensure that they understand the nature and features of the investment services and financial instruments that are selected for clients, and which include sustainability factors.

In terms of the proposed amendments Investment firms are required to take into account sustainability risks (in qualitative or quantitative terms), when complying with the organisational requirements and to integrate sustainability risk into their risk management policies and procedures. In addition, in their conflicts of interest policies need to also take into account any potential conflicts which may damage the client's suitability preferences.

Moreover, when providing financial advice and portfolio management, investment firms will need to carry out a mandatory assessment of sustainability preferences of clients, which are to be taken into account in the selection process of the financial instruments recommended to those clients. These amendments will also clarify that sustainability preferences are to be addressed within the suitability process only once the client's investment objectives have been identified.

There are three categories of financial instruments considered integral to sustainability preferences, primarily:

a) financial instruments pursuing a minimum proportion of sustainable investments in economic activities that qualify as environmentally sustainable under Article 3 of Regulation 2020/852 (the Taxonomy Regulation;
b) financial instruments pursuing a minimum proportion of sustainable investments, where such proportion is determined by the client;
c) financial instruments eligible for individual sustainability preferences - i.e. consider principal adverse impacts on sustainability factors, where elements demonstrating that consideration are determined by the client.

Investment firms will also be required to provide a report to the client that explains how the recommendation made meets the clients' investment objectives, risk profile, capacity for loss bearing and sustainability preferences.

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