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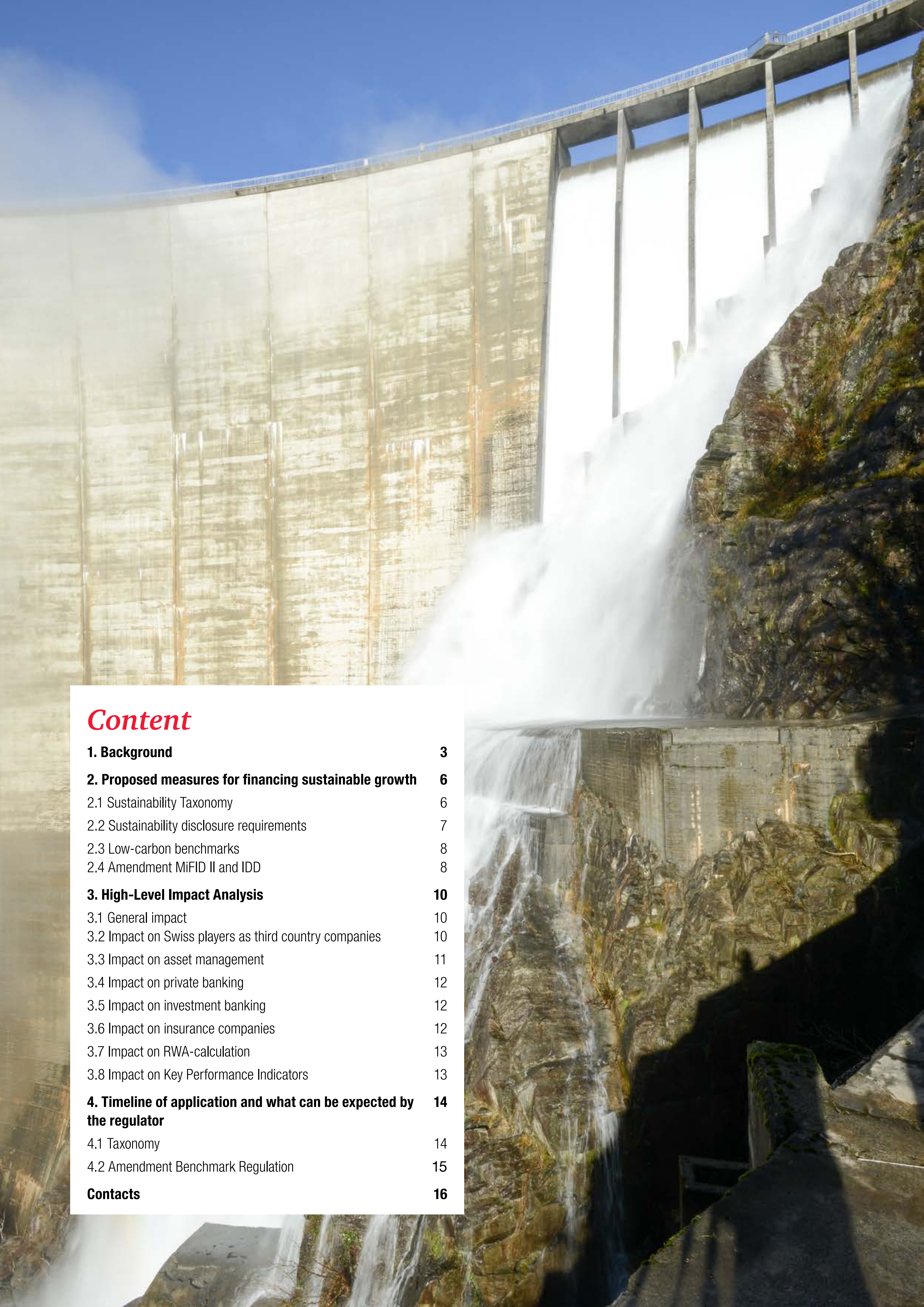
Sustainability – ESG

The massive impact of the Paris Climate Agreement on the financial industry

October 2018



Content

1. Background

The adoption of the **United Nations ("UN") 2030 Agenda for Sustainable Development** on 25 September 2015 and the signing of the **Paris Agreement on Climate Change** on 12 December 2015 sent a strong global message on the necessity to fight climate change by **establishing binding collective commitments towards a low-carbon, resource-efficient and climate-resilient economic system.** However, to achieve the climate and energy objectives agreed in Paris, including a 40% reduction in greenhouse gas emissions, **approximately EUR 180 billion of additional investment will be required annually until 2030.** And the financial industry will have a key role to play in achieving these goals.

To **encourage the financial industry to contribute towards mitigating climate change and including sustainability considerations in its investment decisions,** the European Commission ("EC") first established a High-Level Expert Group ("HLEG") to develop a **European Union ("EU") wide strategy on sustainable financing.** The HLEG thereby identified the following two strategies for Europe's financial system::

1. **Improve** the **financial contribution towards sustainable and inclusive growth.**
2. Strengthen the financial stability by **incorporating environmental, social and governance factors** (so-called "ESG factors") **into investment decision-making.**

In other words, the European Regulator is drawing upon the already heavily regulated financial industry rather than regulating the polluters directly. By defining what is considered a sustainable activity, the incentives to become environmentally friendly will be created by the value of capital provided by the financial industry.

Based on the recommendations by the HLEG, on 8 March 2018 the **EC launched** the **Action Plan on Financing Sustainable Growth,** which lays out a roadmap on how to foster more sustainable investment. The plan also indicates that the EC strongly promotes a more active regulatory role in the market for sustainable investments.

On 24 May 2018, the **EC published** a package of measures implementing several key actions announced in its Action Plan on Sustainable Growth. The package consists of the following **three legislative proposals**:

1. Proposal for a regulation[1] on the establishment of a framework to facilitate sustainable investment;
2. Proposal for a regulation[2] on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341[3]; and
3. Proposal for a regulation[4] on low carbon benchmarks and positive carbon impact benchmarks and amending Regulation (EU) 2016/1011[5];

[1] 2018/0178 (COD) – Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the establishment of a framework to facilitate sustainable investment

[2] 2018/0179 (COD) – Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

[3] Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs)

[4] 2018/0180 (COD) – Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon benchmarks

[5] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014

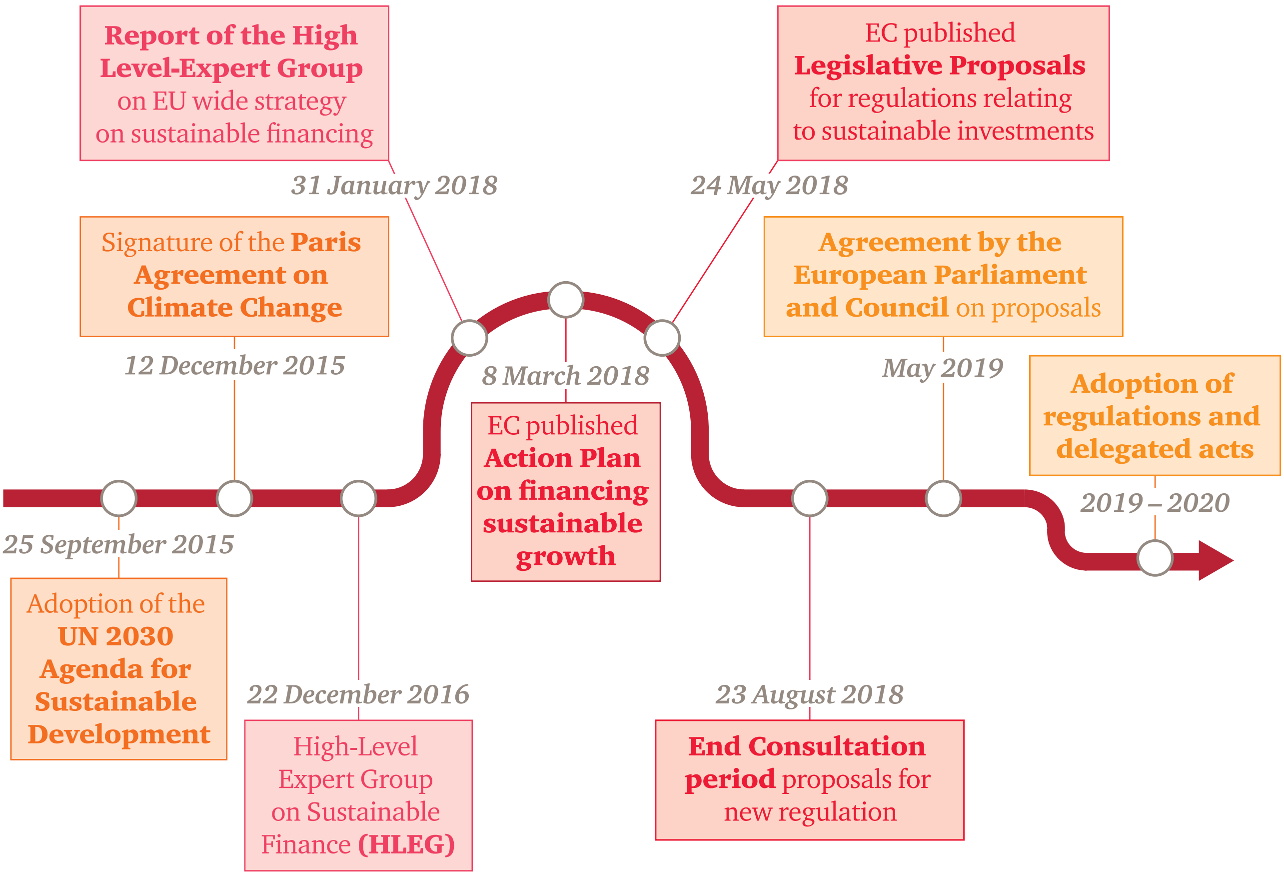
as well as the following **draft amendments to delegated acts:**

1. Draft delegated regulation[6] on the Markets in Financial Instruments Directive ("**MiFID II**") Amendment of Suitability and Appropriateness Testing; and

2. Draft delegated regulation[7] on the Insurance Distribution Directive ("**IDD**") Amendment for the distribution of insurance-based investment products

The legislative proposals and draft amendments to delegated acts aim at:

- ✓ establishing a unified EU classification system of sustainable economic activities ("taxonomy");
- ✓ improving disclosure requirements on how institutional investors include ESG factors in their risk processes; and
- ✓ creating a new category of benchmarks which will assist investors in comparing the carbon footprint of their investments.



[6] COMISSION DRAFT DELEGATED REGULATION (EU) amending Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that directive

[7] COMMISSION DRAFT DELEGATED REGULATION (EU) amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products

2. Proposed measures for financing sustainable growth

Environmental

- Climate change
- Greenhouse gas emissions
- Ressource depletion
- Waste and pollution
- Deforestation

Social

- Working conditions
- Local communities
- Conflict + humanitarian crisis
- Health and safety
- Employee relations + diversity

Governance

- Executive pay
- Bribery and corruption
- Board diversity + structure
- Fair tax strategy

Taxonomy | **Disclosure Requirements** | **Benchmarks** | **Suitability & Appropriateness**

2.1 Sustainability Taxonomy[8]

The first proposed regulation establishes the conditions and the framework within which a **unified classification system on what can be considered an environmentally sustainable economic activity** can be created. Such a classification system is referred to as a “taxonomy”. This is a first and essential step in the efforts to channel investment into sustainable activities. The first proposed regulation establishes harmonised **criteria for determining** whether an **economic activity is environmentally sustainable.** This should give financial institutions and investors more clarity on which activities are considered sustainable so they are able to make more informed investment decisions.

The proposed regulation defines the following six environmental objectives to which economic activities must contribute to be considered environmentally sustainable:

1. Climate change mitigation;
2. Climate change adaptation;
3. Sustainable use and protection of water and marine resources;
4. Transition to a circular economy, waste prevention and recycling;
5. Pollution prevention and control;
6. Protection of healthy ecosystems

The EC is currently working on **identifying in detail the technical screening data** based on which it will be determined if and to what extent economic activities qualify as environmentally sustainable. The EC is thereby taking into consideration existing

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market practices and initiatives as well as the advice of a technical expert group that has been set up to that end. Furthermore, a Platform on Sustainable Finance will be set-up in 2019 which will advise the EC on the further development of the taxonomy and its impact.

Once developed, the taxonomy will have to **be applied by:**

- **national and EU regulators** when determining requirements on financial market participants regarding financial products that are marketed as environmentally sustainable
- **financial market participants offering financial products as environmentally sustainable**

The operational part of the proposed regulation and the detailed taxonomy will not apply until six months after the adoption of the relevant future delegated acts by the EC. This should provide financial market participants with more time to prepare for the application of the new rules.

2.2 Sustainability disclosure requirements[9]

The second proposed regulation will introduce consistency and clarity on how financial intermediaries, such as **asset managers, private bankers, investment bankers, insurance companies, pension funds, or any financial advisers** should integrate ESG factors into their investment decision-making, portfolio management and advisory process. In addition, they will be required to demonstrate how their investments are aligned with ESG objectives and will also have to disclose how they comply with these duties. With regard to the latter, the second proposed regulation introduces obligations on ESG factors to be included in risk processes.

In other words, harmonised rules on transparency of ESG risks have to be applied by the following financial market participants:

- **Asset managers** which are regulated under the directive on undertakings for collective investment in transferable securities ("UCITS"), the alternative investment fund managers ("AIFM") directive, the European venture capital funds ("EuVECA") and European social entrepreneurship funds ("EuSEF") regulations
- **Investment firms** which provide **individual investment management and investment advisory services**
- **Insurance distributors** which are regulated by the IDD
- **Insurance intermediaries** which provide **insurance advice** with regard to **or make available insurance-based investment** products ("IBIPs")
- **Occupational pension funds** which are regulated by the institutions for occupational retirement provision directive ("IORP II")

The proposed rules **cover all financial products offered** (collective investment schemes, insurance products, structured products, derivatives, managed portfolios, pension schemes, etc.) **and services** (individual portfolio management and investment advice) **provided** by the aforementioned financial market participants, regardless of whether they follow sustainability investment objectives or not.

The affected financial market participants will have to disclose:

- the **procedures in place to integrate ESG risks** into their investment management and advisory process
- the extent of the expected monetary **impact of the ESG risks on the returns** of the product or service provided, irrespective of whether sustainable investment objectives are pursued or not, and
- how the remuneration policies are consistent with (i) the integration of the sustainability risks and (ii) the sustainable investment target of the financial product

Furthermore, if asset managers, insurance undertakings or occupational pension funds claim that they pursue a strategy with sustainable investment objectives, they will have to **disclose information on how they adhere to those sustainability objectives**

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in their investment decisions. This includes the **disclosure of the sustainability or climate impact of their products** and portfolios.

For financial products targeting the reduction in carbon emissions, the information and the degree (quantification) as well as the monetary impact to which extent the product in question participates in **the reduction in carbon emissions** also needs to be disclosed.

Last, **all research which is undertaken and/or provided by financial intermediaries needs to consider ESG factors,** as they will be imperative factors for the decision-making process.

The details and exact requirements of the sustainability disclosure requirements will be worked out and further specified through delegated acts, which will be adopted by the EC at a later stage.

2.3 Low-carbon benchmarks[10]

The third proposed regulation will amend the existing EU benchmark regulation that specifies minimum standards for benchmarks to avoid misleading consumers. The proposed regulation will thereby create a **new category of benchmarks** comprising two types of benchmarks:

1. low-carbon benchmarks and
2. positive carbon impact benchmarks

The low-carbon benchmark is based on ‘decarbonising’ a standard benchmark. This means that the underlying stocks would be selected on account of their reduced carbon emissions when compared with stocks constituting a standard benchmark.

The positive-carbon impact benchmark is a more ambitious version that would be in line with the second objective of the Paris Climate Agreement. Here, the underlying stocks would be selected on account of their carbon emission savings exceeding the stocks’ residual carbon footprint.

These new categories of benchmarks should:

- foster a **generally accepted market standard** to measure a company’s carbon footprint;
- provide investors with **better information** about the carbon footprint of their investments; and consequently also
- help investors **compare** the carbon footprint of investments.

As per the proposal, benchmark statements shall also contain an explanation of how ESG factors are reflected in the respective methodology for each benchmark or family of benchmarks

2.4 Amendments to MiFID II[11] and IDD[12]

Next to the proposed regulations, the EC requested feedback by 21 June 2018 on amendments to delegated acts under the MiFID II and the IDD to include ESG considerations into the advice that investment firms and insurance distributors offer to their clients.

According to the proposed rules, investment firms should also consider the **sustainability preferences of each client** when assessing whether an investment product meets their client’s needs. This should help a wider range of investors access sustainable investments.

This means that the

- **investment advices** process
- the **portfolio management process,** and
- the **disclosure** requirements

have to be **revised** and enriched with ESG criteria.

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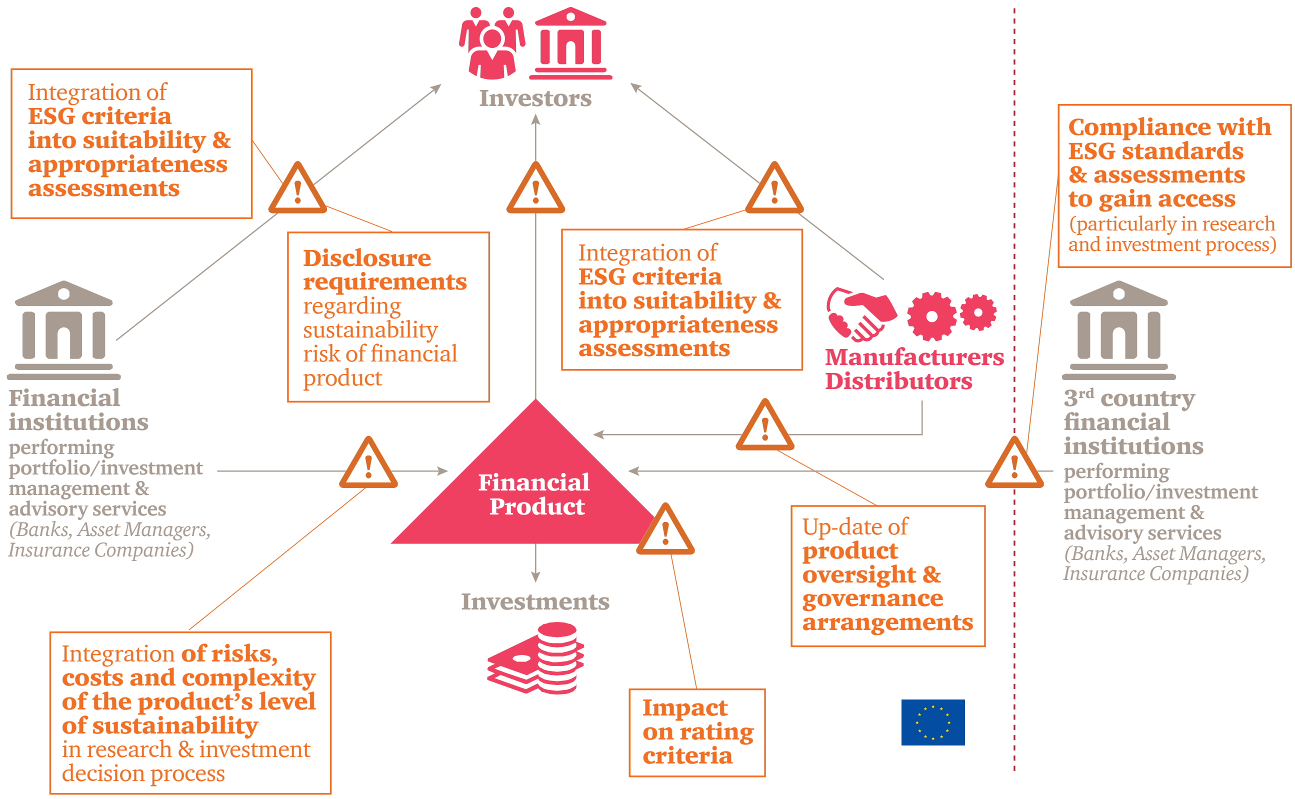
11 COMISSION DRAFT DELEGATED REGULATION (EU) amending Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU

12 COMMISSION DRAFT DELEGATED REGULATION (EU) amending Delegated Regulation (EU) 2017/2359

Legal requirements	Article	MiFID II Amendments (sample)
1. Definitions	Art. 2 MiFID II	In Article 2 points (7), (8) and (9) are added as follows: (7) **'ESG preferences'** means a client's or potential client's preferences for **environmentally sustainable investments, social investments or good governance investments;** (8) **'ESG considerations'** means a consideration related to **environmentally sustainable investments, social investments or good governance investments;** (9) **'environmentally sustainable investment'** means an **investment in an economic activity that contributes to an environmental objective**
2. Information about the investment firm	Art. 48 MiFID II	In Article 47 (3), point (d) is replaced as follows: "Investment firms shall provide clients or potential clients in good time before the provision of investment services or ancillary services to clients or potential clients with a **general description of the nature and risks of financial instruments,** taking **into account in particular any ESG considerations and the client's categorisation** as either a **retail client, a professional client or eligible counterparty"**
3. Investment advice	Art. 52 MiFID II	Article 52, paragraph 3 is replaced as follows: "(…) the factors, taken into consideration in the selection process used by the investment firm to recommend financial instruments, such as risks, costs and complexity of the financial instruments or, where relevant, **ESG considerations"**
4. Suitability & Appropriateness	Art. 54 MiFID II	Article 54 in paragraph 2, point (a) is replaced as follows: (2a) (…) and any preferences, including environmental, social and governance considerations. (5) (…) hold the investment, his or her ESG preferences, if any, (…) (9) (…) including any environmental, social and governance considerations etc.

3. High-Level Impact Analysis



3.1 General impact

The proposed measures by the EC will have **a big impact** on the financial industry as **all types of different sectors and financial intermediaries** (e.g. as regards banks: private banks, investment banks, retail banks and universal banks) **will be affected.** This is due to the fact that the whole investment process, starting from research to the actual investment, as well as the sales process have to be reviewed and amended.

Moreover, there could be a potential impact on the **own funds calculation,** which again will have an impact on the price of the products and therefore the attractiveness of the financial products.

Depending on the nature of the business and applicable regulatory regime, the criteria below have to be **disclosed in regulatory reports** of AIFMs, management companies of UCITS, pension benefit statements, venture capital funds, social entrepreneur funds, MiFID II portfolio and investment manager and their required marketing and research communication.

In particular, the following criteria have to be disclosed on a **pre-contractual** basis for **each financial product** (list not exhaustive):

- **Process and conditions** applied to integration sustainability risk in investment decisions
- The extent to which sustainability risk is expected to have a relevant **impact on the returns** of the financial products
- Internal **remuneration policies** with sustainability investment targets
- **Links to any index** and how the index and its **composition** is aligned with the product/service
- Which **methodologies** have been used to assess, measure and monitor the impact of the investment
- Underlying **data sources**
- Relevant **sustainability indicators**

Notwithstanding the specific impact for the specific financial intermediaries as mentioned in the following chapters, there are areas affected that are independent from the respective business model. These are as follows:

Area	Topics	Degree of impact (1–5)
Cross Divisional Topics	Repapering – client contracts	**5**
	Remuneration – Key Performance Indicators (“KPIs”)	**5**
	Marketing material	**4**
	Mortgage business	**3**
	Asset-Liability Management (“ALM”) - consideration of sustainability risks/new assets/refinance	**3**

3.2 Impact on Swiss players as third country companies

To be granted EU market access to service ESG products, **Swiss players as third country companies have to comply with ESG standards.** Thus, a third country company would not be permitted to sell/buy ESG products if the required standards are not met.

Moreover, where Swiss market intermediaries

- aim to provide financial services to an EU-domiciled client, or
- want to distribute financial products into the EU or
- are affected by MiFID II due to cross border exposure, or
- are affected by IDD due to cross border exposure,

they have to follow the standards of the Benchmark Regulation.

3.3 Impact on asset management

ESG standards have a high impact on the asset management business because ESG elements of the **portfolios for collective investment schemes** have to be computed and implemented – for both UCITS and Alternative Investment Funds (“AIFs”).

Therefore, affected asset managers have to take into consideration in the **investment process** and **structuring of collective investment schemes** the risks, costs and complexity of the financial instruments’ level of sustainability. These aspects have to be integrated into the annual reports as well as the regular reports of the asset manager and their managed collective investment schemes.

Area	Topics	Degree of impact (1–5)
Asset Management	UCITS Products	**5**
	AIFs	**5**
	Document Production	**5**
	Investment Strategy	**5**
	UCITS Management Companies	**4**
	AIFM	**4**

3.4 Impact on private banking

Retail or professional clients have to receive a **general description of the nature and risks** of the financial instruments, taking into account in particular any **ESG considerations** and the client's categorisation. In this context, the **suitability and appropriateness questionnaires** and all related internal processes and guidelines will have to undergo revisions.

Therefore, depending on the exposure of the serviced retail and professional client, the impact of the revised MiFID II by considering ESG standards, is rather high.

Area	Topics	Degree of impact (1–5)
Private banking/ wealth management	Investment advice	4
	Portfolio management/discretionary mandates	4
	General disclosure requirements	4
	Transparency	3
	Product selection/investment policy	3

3.5 Impact on investment banking

By establishing the ESG standards, all investment products and especially **corporate bonds,** "green corporate bonds" will be impacted by the definition of the rating **of an investment product** (e.g. from BBB to A rating). Used **benchmarks** need a revisit and to be checked on their compliance with the
ESG standards.

Research for both the buy and sell-side has to reflect ESG standard taxonomy parameters to fit into the new taxonomy standards of sustainable investments.

Area	Topics	Degree of impact (1–5)
Investment banking	M&A	5
	Benchmarks	5
	Research (buy and sell side)	5
	Corporate actions	5
	Refinancing	3

3.6 Impact on insurance companies

Insurance companies are affected if they act as a manufacturer or distributor of **green insurance-based investment products (IBIPs).** Revisits of their product oversight and governance arrangements have to be conducted to ensure that they are in line with their clients' interests in terms of suitability and appropriateness.

Area	Topics	Degree of impact (1–5)
Insurance companies	Insurance-based products – IBIPs	4
	Disclosure requirement	4

3.7 Impact on RWA–calculation

The required capital ratio is calculated as the ratio of two simple components, namely, a financial institution's capital (nominator) and risk-weighted assets (RWA) (denominator). In this context, there is an anticipated impact on RWA because the EC believes that **lowering capital requirements for sustainable financial products** will improve the contribution of finance to sustainable and inclusive growth.

Area	Topics	Degree of impact (1–5)
Risk-weighted assets (RWA)	RWA calculation	**5**

3.8 Impact on Key Performance Indicators

The ESG factors have an impact on the accurate setup of the financial institution and as well as on its employees. They have to manage all conflicts of interest with respect to their key performance indicators in a fair and consistent manner to ensure ESG awareness across different products and to promote investor protection as well as market integrity.

Consequently, financial institutions have to have in place an **effective organisational and administrative framework that ensures all employees across divisions follow the same sustainability criteria.**

4. Timeline of application and what can be expected by the regulator

In a next step the legislative proposals of the EC will be discussed in the European Parliament and the Council. The EC, together with an expert group it is currently setting up, will continue to work on taxonomy standards, green bonds standards and corporate reporting.

4.1 Taxonomy

Legal requirements	Description	Applicable as of
1. Criteria for economic activities	**Economic activity** shall be **environmentally sustainable** where that activity **contributes substantially** to **one** or **more** of the **environmental objectives** etc.	01/07/2020
2. Use of the economic activities criteria	**Member States** shall **apply** the **criteria** for **determining environmentally sustainable economic activities.**	01/07/2020
3. Environmental objectives	For the purposes of this Regulation, the following shall be environmental objectives such as **climate change mitigation, protection of healthy ecosystems.**	01/07/2020 – 31/12/2022
4. Climate change mitigation	An **economic activity** shall be considered to **contribute** substantially **to climate** change mitigation (e.g. generating, storing or using **renewable energy** or climate-neutral energy).	01/07/2020
5. Climate change adaptation	**Climate change** adaptation through **preventing** or reducing the location- and context-specific **negative effects** of climate change.	01/07/2020
6. Use and protection of water and marine resources	**Contribution** substantially to **sustainable use** and protection of **water** and **marine resources** (e.g. protecting the aquatic environment from adverse effects).	31/12/2022
7. Circular economy and waste prevention and recycling	**Contribution** substantially to the transition to a **circular economy** and waste prevention and **recycling** (e.g. improving the efficient use of raw materials in production).	31/12/2021
8. Pollution prevention and control	**Contribution** substantially **to pollution prevention** and control through **reducing** air, water and soil pollutant **emissions** other than greenhouse gasses etc.	31/12/2021
9. Protection of healthy ecosystems	**Contribution** substantially to **healthy ecosystems** (e.g. **nature conservation** (habitats, species)).	31/12/2022
10. Significant harm to environmental objectives	An **economic activity** shall be considered as **significantly harming** (e.g. **climate change mitigation,** climate change **adaptation,** sustainable use and **protection** etc.).	01/07/2020
11. Minimum safeguards	**Minimum standards** ensure that the **principles** and **rights set** out in the **eight fundamental conventions in the International Labour Organisation's declaration.**	01/07/2020

4.2 Amendment Benchmark Regulation

Legal requirements	Article	Amendments	Applicable as of
1. Definitions	Art. 3 BMR	In Article 3 points 23(a) and (b) are inserted as follows: (23a) **'low-carbon benchmark'** means a benchmark where the underlying assets are selected so that the resulting benchmark portfolio has less carbon emissions (…) (23b) **'positive carbon impact benchmark'** means a benchmark where the underlying assets are selected on the basis that their carbon emissions savings exceed the asset's carbon footprint (…)	Expected 2020
2. Transparency of methodology	Art. 13 BMR	Article 13 is amended with lit. (d) and (2a) as follows: (d) **Explanation** of **how the key elements** of the methodology **reflect environmental, social or governance ('ESG') factors** (2a) The **Commission** shall be empowered **to adopt delegated acts** to specify further the **minimum content of the explanation**	
3. Different types of benchmark	Title 3 BMR	In Title III the following Chapter 3a is inserted: (19a) The requirements laid down in Annex III shall apply to the provision of, and contribution to, **low-carbon or positive carbon impact benchmarks** in addition to, or as a substitute for, the requirements of Title II, III and IV The Commission shall be empowered **to adopt delegated acts** to specify further **the minimum standard**	
4. Benchmark statement	Art. 27 BMR	In Article 27 the following paragraphs 2a is inserted (2a) A **benchmark statement** shall contain an explanation of how **environmental, social and governance factors** are reflected for each benchmark or family of benchmarks provided and published which pursue or take into account ESG objectives.	

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