

# Green Insurance: Pre-contractual ESG-Disclosure

JULY 2021





## Pre-contractual ESG disclosure for complex financial products: emerging challenges

The issue of sustainability continues to influence the financial services industry. On February 2, 2021, the European Supervisory Authorities (**ESAs**) published their Joint ESA Final Report on Regulatory Technical Standards on the content, methodologies and presentation of disclosures (the **RTS**) under the Regulation on sustainability-related disclosure in financial services (**SFDR**).<sup>1</sup> The SFDR is the centerpiece of the EU's "Action Plan: Financing Sustainable Growth"<sup>2</sup> that aims to raise the funds necessary to mitigate and adapt to climate change<sup>3</sup> through financial and insurance markets participants, including retail clients. The RTS provide further detailed rules on the entity-level disclosures of, amongst other things, the adverse sustainability impact, as well as product-related, pre-contractual disclosure obligations. The recent decision by the German Federal Constitutional Court to include the burden on future generations in legislative decisions<sup>4</sup> has recently added another dimension to the issue of sustainability.

This Client Alert looks at the pre-contractual disclosure obligations as the centerpiece of the new disclosure obligations, applicable to entities in the scope of the SFDR and notably to insurance firms. While the RTS will only be applicable from 1 January 2022,<sup>5</sup> the majority of obligations of the SFDR do already apply since March 10, 2021.<sup>6</sup> With principle-based style of the SFDR disclosure obligations the RTS may serve as guidelines for a compliant disclosure of insurance companies and in-scope investment firms even before they officially apply. As such, insurance companies and other in-scope entities had to use the limited time to put in place the relevant procedures and documentation. Whilst the RTS and SFDR have been on the statute books since February, challenges in terms of compliance and usability have come to light by now.

While the merits of a taxonomy and the transparency of green investments are without doubt, the disclosure requirements may not be fit for purpose. Also, the requirements still leave a lot of questions for bundled products such as unit-linked policies unanswered. In light of the high amount of uncertainty in respect to the disclosures, in-scope entities may wish to closely align their approach with their regulator's expectations.

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1 Final Report on draft Regulatory Technical Standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a(3), Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088/JC 2021 03; available [here](#) ; (last accessed February 23, 2021).

2 Communication from the Commission to the European Parliament, the European Council, the European Central Bank, the European Economic and Social Council and the Committee of the Regions, Action Plan: Financing Sustainable Growth, dated March 8, 2018, COM(2018) 97 [here](#) (last accessed February 23, 2021).

3 See Articles 2(1) (a) and (b) of the Paris Accords.

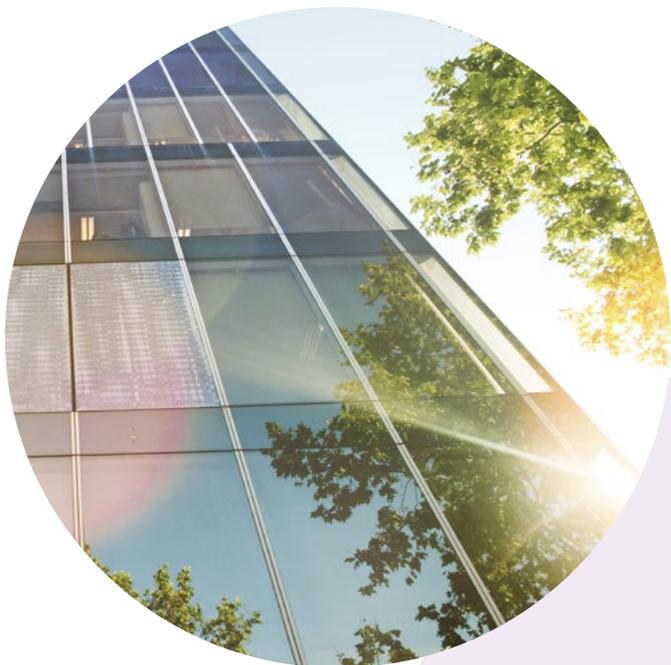
4 See order of German Constitutional Court ("Bundesverfassungsgericht") dated March 24, 2021 available [here](#) (last accessed June 9, 2021)

5 Article 74 para 2 RTS. By way of derogation, the reporting on scope 3 GH emissions in Tables 1 and 2 of Annex I of the RTS apply from 1 January 2023.

6 Selected obligations have to be complied with from June 2021 and January 2022 respectively.

## The European ESG framework and its German implementation

With the publication of the RTS, the European Commission has completed the EU's sustainability disclosure framework, which is composed of the SFDR and the EU's Regulation (EU) 2020/852 (**Taxonomy Regulation**). The sustainability disclosure framework closely interrelates with various other amendments in EU level 1,<sup>7</sup> level 2<sup>8</sup> and level 3<sup>9</sup> legislative instruments to foster sustainability in the EU's financial system. While, as EU Regulations, both the Taxonomy Regulation and the SFDR are directly applicable in the member states, certain provisions, notably in respect to competent authorities (i.e. supervisors) and sanctions, have to be set out on the national level.<sup>10</sup> The German regulator has incorporated the necessary provisions in an Act for the promotion of Germany as a home state for funds (*Fondsstandortgesetz – Act*),<sup>11</sup> which has been passed by and the German Parliament (*Bundestag*) and has been approved by the German Federal Council (*Bundesrat*) on Mai, 28, 2021. The Act will be effective from August 2, 2021.<sup>12</sup>



## Recap on the scope of the SFDR and the RTS – the view from the insurance sectors

The SFDR as well as the RTS follow a cross-sectoral approach and apply to insurances as well as financial services undertakings. Thereby, the regulatory obligations for in-scope entities vary depending on whether the entity qualifies as a financial market participant or a financial advisor. For the insurance sector, the SFDR applies notably to insurance firms making available insurance-based investment products (**IBIPs**), institutions for occupational retirement provisions (**IORPs**) i.e., pension funds, and providers of pan-European personal pension products (**PEPPs**).

For the financial sector, the SFDR applies to fund managers managing alternative investment funds (**AIFs**) and Undertakings for the Collective Investment in Transferable Securities (**UCITS**) i.e. regulated mutual funds. Equally, credit institutions and investment firms qualify as financial market participants if they provide financial portfolio management. Financial advisors include intermediaries as well as insurance undertakings, credit institutions, investment firms, and fund managers providing insurance or investment advice.

The following table provides an overview on the respective disclosure obligations and how they apply to financial market participants and financial advisors respectively.

7 This includes amendments to the Benchmark Regulation, MiFID II the UCITS Directive and the AIFMD.

8 Notably in respect to MiFID2 regulatory framework the amendments to the Delegated Regulations 2017/565 and 2017/593; in respect to the UCITS Directive 2010/43/EU and DelVO 231/2013.

9 This includes notably ESMA Product Governance Guidelines and the ESMA Suitability Guidelines.

10 The legislative draft finds adjustments are necessary in order to provide clarity to the legal practice of the regulation, which in itself is directly and immediately applicable (see p. 3 of the draft Act).

11 (Drucksache 51/21).

12 Forwarded to the Bundesrat on 21. January 2021.

	Financial Market Participant	Financial Advisor	Type of disclosure
<b>Transparency of sustainability risk policies</b> (Art. 3 SFDR)	x	x	Website
<b>Transparency of adverse sustainability impacts</b> (Art. 4 SFDR)	x	x	Website, RTS guidance <sup>13</sup>
<b>Transparency of remuneration policies</b> (Art. 5 SFDR)	x	-	Remuneration policy
<b>Transparency of the integration of sustainability risks</b> (Art. 6 SFDR)	x	x	Pre-contractual disclosure
<b>Transparency of adverse sustainability impacts at product level</b> (Art 7 SFDR)	x		Pre-contractual disclosure (by 30 Dec 2022)
<b>Transparency of the promotion of environmental or social characteristics</b> ("Light Green Products") (Art. 8 SFDR)	x	x	Pre-contractual disclosure, RTS template <sup>14</sup>
<b>Transparency of sustainable investments</b> ("Dark Green Products") (Art. 9 SFDR)	x	x	Pre-contractual disclosure, RTS template <sup>15</sup>
<b>Transparency of the promotion of environmental or social characteristics and of sustainable investments</b> (Art. 10, 11 SFDR)	x	-	Website, RTS guidance, periodic reports <sup>16</sup>

13 Please note that Art. 4 para 6 and 7 SFDR shall apply from January 1, 2022 (Art. 20 para 3 SFDR).

14 Please note that Art. 8 para 3 SFDR shall apply from January 1, 2022 (Art. 20 para 3 SFDR).

15 Please note that Article 9 para 5 SFDR shall apply from January 1, 2022 (Art. 20 para 3 SFDR).

16 Please note that Article 11 para 1 and 3 shall apply from January 1, 2022 (Art. 20 para 3 SFDR). The templates can be found in Annexes III and IV of the RTS.

## An overview on pre-contractual disclosure

The centerpiece of both the SFDR and the RTS is the pre-contractual disclosure regime that applies to all financial products, including IBIPs, IORPs, UCITS, AIFs and portfolios. The following section first provides an overview of the new regulation and then looks into a selection of structural and practical issues for the SFDR and the accompanying RTS.

The new pre-disclosure requirements apply to all in-scope financial products. This includes products with environmental or social characteristics (so called **Light Green Products**), those with sustainable investment objectives (so called **Dark Green Products**) and those that fall into neither category. The SFDR defines a sustainable (Dark Green) investment as an investment that contributes to an environmental or social objective, provided that the investment does not significantly harm certain environmental or social objectives and provided that the investee company follows good governance rules<sup>17</sup>. The SFDR and the Taxonomy Regulation do not define environmental or social characteristics. Recital 19 of the RTS sets out that one way to promote environmental or social characteristics is to take into account principal adverse impacts of investment decisions. Beyond that, the non-exclusive list of objectives in the definition of Dark Green Products may serve as guidance for what characteristics are deemed “environmental” or “social”.<sup>18</sup>

The SFDR and, insofar as the environmental characteristics are relevant, the Taxonomy Regulation sets out detailed rules on pre-contractual disclosures, which the ESAs have compiled in Annexes II and III of the RTS. Light Green Products have to complete Annex II (environmental and social characteristics), while for Dark Green Products Annex III (sustainable investment objective) has to be attached to the sectoral documentation.

Where the respective in-scope entity deems sustainability risks not to be relevant, it has to provide a clear and concise explanation of the reasons. The RTS do not set out a template for such disclosure. While a market practice has to emerge, in-scope entities may, in terms of detail, align such disclosures with the amount of detail of Annex II and III of the RTS. Please note that the templates in Annex II and III already incorporate disclosures on principal adverse impact, which apply only from December 30, 2022.

The respective pre-contractual disclosure documents have to be attached to specific sectoral pre-disclosure documentation. These vary considerably in terms of detail and audience, ranging from prospectuses such as for UCITS, to comprehensive information on risks and costs associated with IBIPs.

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17 Article 2 para 17 of the SFDR. This includes amongst others investments into “environmentally sustainable economic activities” within the meaning of the Taxonomy Regulation.

18 For environmental characteristics the definition of environmentally sustainable economic activities in the Taxonomy Regulation may provide further guidance (cf. Recital 19 of the Taxonomy Regulation).

## A structural note on pre-contractual disclosure

Due to the narrow scope of the mandate of the ESAs, which is to devise a single set of templates for all financial products, the RTS has to be read as a trade-off in more than one way.

Looking at this issue closer, however, there is neither the need nor an obvious advantage in a uniform template across product classes. On the contrary, having to account for different audiences, different sectoral disclosure obligations and different purposes of sectoral disclosure would reduce the effectiveness of the disclosure for each product class and would try to compare apples with pears.

First, there is no need to devise a single set of templates for different financial products. The SFDR sets out to compare insurance products with investment products and managed portfolios. An investor, however, will not likely compare the sustainability of an IBIP with the sustainability of a financial portfolio. Rather, an investor will compare one IBIP to another IBIP and thus require information that compares the sustainability features of these products with one another.

Second, the templates are not aligned with the documents they complement. Pre-contractual sectoral disclosure regulation varies considerably between advised and non-advised sales, as well as across financial products, in terms of the recipient of the information, the purpose of the information and its granularity. Sectoral documentation that SFDR introduce range from UCIT prospectuses on the one hand to comprehensive sets of information on the other. Opting for the middle ground between comprehensibility suited to the retail investor and prospectus-like comprehensiveness, the ESAs struggled to fit the templates to the needs of all market participants. This has been evidenced by the public survey conducted during the consultation phase, which showed that the information was too simplified for institutional investors and too complex for retail investors. During consumer testing, the majority of respondents found the text complicated and hard to read,<sup>19</sup> while others had not been able to read the complete document, were not interested or did not know about it. Only a substantial minority provided positive feedback. While the study has been conducted based on the draft RTS, in light of only

minor changes between both versions, it is likely that the majority of retail investors will not make use of the disclosure, even where they were interested in sustainability.

Third, because financial products work differently and thus account for sustainability in different ways, the templates had to take a high-level approach to capture all financial products. Comprehensiveness, however, comes at the expense of comprehensibility. Questions in the templates such as “What environmental and/or social characteristics are prompted by this financial product?” may not pose much of a challenge in respect to AIFs or UCITS, which may take this information from investment rules or strategies. The answer, however, may not be straightforward in respect to portfolios or IBIPs, which have changing positions or a range of underlying objects amongst which the investment is only selected after the conclusion of a contract.

Fourth, the SFDR leaves relevant issues unanswered and are also likely to cause duplication of work in case financial services providers combine their services in bundled products. Perfect examples of this issue are IBIPs such as unit-linked policies offering an open investment strategy for UCITS and AIFs to policyholders, which the investment manager of the insurer will implement based on the policyholder’s personal investment strategy. In light of the one-size-fits-all approach of the SFDR, the policyholder should receive all required information on sustainability by the time he or she decides upon their investment. However, in the case described, the investor (policyholder) does not decide upon a specific investment; they only determine a general investment strategy that an investment manager will implement thereafter. How can the insurer reasonably inform the policyholder on sustainability issues in these circumstances? The SFDR framework does not answer this question. Further questions arise: based on a literal interpretation of the SFDR framework, the UCIT and the AIF would both be subject to SFDR reporting requirements and so is the insurer. Do these two layers of reporting, i.e. reporting by the funds and the insurance undertaking, actually promote transparency for the investor or rather cause additional costs that the insurer will have to justify and the policyholder have to bear?

19 Consumer testing pre-contractual and periodic ESG financial product information.

## Financial products with a range of underlying products

The previous example shows that SFDR disclosure for financial products with a range of underlying products is much more complex than the uniform template would suggest. What makes these products different is that in choosing the product the investor only makes an abstract investment decision, e.g. for a certain IBIP, which in turn offers different financial products that the investor can use for their retirement savings.

Therefore, a distinction has to be made between the underlying assets, which may or may not be green, and the disclosure obligations in respect to the underlying, as well as the “greenishness” of the IBIP or other financial product itself.

Pursuant to Recital 41 of the RTS, it is necessary to ensure that end investors are informed of the potential sustainability-related performance of such products and thus require information on “the options that promote environmental or social characteristics or have sustainable investment as their objective”. Where underlying investment options qualify as either Light Green or Dark Green Products, the information relating to the financial product should be provided in relation to those options.<sup>20</sup> Thus, financial products that offer a range of underlying investment options have to include the respective disclosure for each green investment option.<sup>21</sup> Where a large number of investment options, or even just strategies, would prevent an end-investor from receiving clear and concise information, a reference can be made to a location of that information in the annexes of other disclosures made pursuant to sectoral rules.<sup>22</sup> Unit-linked policies and other PRIIPs could be a use case for this approach.

While the Recitals provide guidance on the investment options, the Recitals do not provide further context on whether, in addition to the templates of the option, the overall IBIP also has to provide the disclosure set out in the template or whether disclosure regarding all options equals the disclosure of the overall product.<sup>23</sup> The Recitals refer only to an “appropriate level of information” in respect to the overall product. End investors should be provided with a summary list of the sustainability-related underlying investment options and a clear indication of where sustainability-related information on them can be found. This list should be appropriately categorized.

The summary list should be a requirement that comes on top of the disclosure of the respective annexes and that applies to all IBIPs that are themselves Light or Dark Green Products. Indeed, the RTS are not allowed to narrow the scope of the SFDR, which explicitly includes IBIPs and IORPs as financial products and requires information on that product as opposed to information on aspects of the product. Therefore, IBIPs that do not only offer Light or Dark Green investment

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<sup>20</sup> Recital 42.

<sup>21</sup> See also Recital 44 which refers to a corresponding high number of annexes of information.

<sup>22</sup> Recital 44. For advised and non-advised sales, Recital 44 allows a focused disclosure only on the option that the end investor is actually considering investing in.

<sup>23</sup> Recital 42.

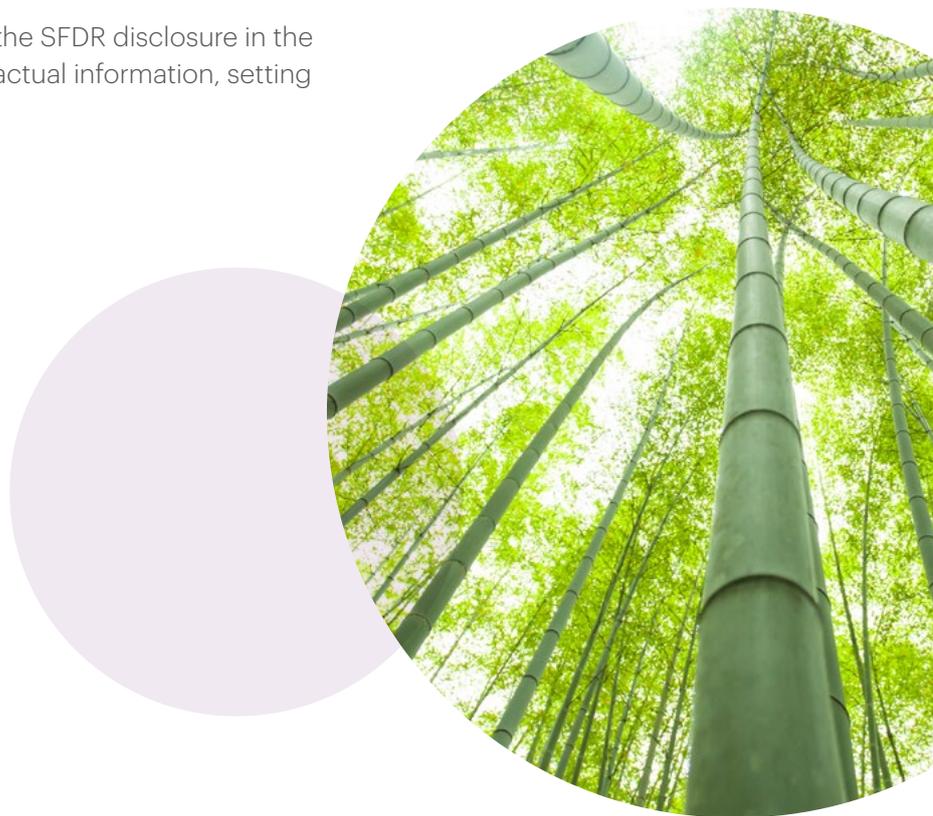
options but are Light or Dark Green Products themselves, have to provide the information in the templates in respect to the overall product in addition to the information on each option. Pursuant to Recital 41, a financial product with underlying options only qualifies as Dark Green if all underlying financial products are likewise Dark Green Products. Accordingly, Light Green financial products are products with underlying options that include only Light or Dark Green Products.<sup>24</sup>

### Enforcement in Germany

While the SFDR allows member states to adopt or maintain more stringent provisions on the publication of climate change adaptation policies or other sustainability issues,<sup>25</sup> the Act is a minimum implementation, which does not go beyond the requirements set by the SFDR. Under the SFDR, member states shall ensure that the competent authorities designated in accordance with the respective sectoral legislation monitor compliance with the requirements of the SFDR and have the necessary power to exercise this function.

Importantly, the Act follows the home state principle. Thus, from a German perspective, entities providing services on a cross-border basis into Germany would thus need to comply only with the SFDR and RTS as interpreted by the competent authority in their home state.

On the sanctions side, the Act incorporates the SFDR disclosure in the sanctions catalogue applicable to pre-contractual information, setting out administrative fines of up to €5 million.<sup>26</sup>



24 This being said, according to Recital 21 Light Green Products, in turn, may also invest in underlying assets, some of which may not themselves qualify as sustainable or contributing to the respective characteristics. This includes hedging instruments, unscreened investments for diversification purposes, investments for which data is lacking or cash held as ancillary liquidity. This however, it is a matter of the disclosure of the Light Green Product and a different question than whether the overall product may invest in non-green investments.

25 See Recital 28 of the SFDR.

26 Section 120 para 8 point 35 in conjunction with Section 120 para 20 WpHG; Section 332 para 4k VAG-Draft in conjunction with Section 332 para 5 VAG Draft.

## Outlook

Although the RTS has assisted in the implementation of the EU's sustainability disclosure framework, the EU's Action Plan has not yet been fully transposed into EU and national law.

In respect to the interaction between disclosure obligations and other sectoral regulation, further level 2 and 3 legislative instruments are either already in the pipeline or are expected to be introduced in the foreseeable future. Notably, the Delegated Regulation 2017/565<sup>27</sup> on the organizational requirements and operating conditions for investment firms and the Delegated Regulation (EU) 2017/2359<sup>28</sup> on the distribution of IBIPs are currently under review. Under the drafts, investment and insurance advisors will be required to query investors on their sustainability preferences. As both documents have been published prior to the SFDR, some fine-tuning can be expected for the final drafts of these level 2 instruments. Also, EIOPA has been tasked with devising guidelines specifying how IPORs investment decisions and risk assessments are to take into account environmental, social and governance risks under Directive (EU) 2016/2341 (**IORPs Directive**).<sup>29</sup>

While these instruments may be able to level some of the frictions of the SFDR, the main problem with the SFDR remains the standardization of pre-contractual disclosure across financial product groups, which cannot be changed by level 2 or 3 legislative instruments. Under the SFDR, the Commission is tasked with evaluating the application of the SFDR and reporting on its findings by December 30, 2022.<sup>30</sup> With definitive views expressed by the ESAs on standardization across product groups as well as the less than optimistic consumer testing, it is likely that the report will be accompanied by a legislative proposal bringing further clarity to the sustainability disclosure framework.

**The lawyers of our financial institutions regulatory team are assisting a number of bank and other regulated firms on regulatory matters. If you would like to discuss any of the items mentioned, or how they may affect your business more generally, please contact any of our key contacts or the wider team of our financial institutions regulatory team.**

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27 Proposal of Commission Delegated Regulation (EU) .../... of XXX amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive, initial draft available [here](#) (last accessed 5 March 2021).

28 Commission delegated Regulation (EU) .../... of XXX amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products, available [here](#) (last accessed 5 March 2021).

29 See Recital 29 of the SFDR.

30 See Article 19 of the SFDR.

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