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Understanding SFDR and IDD

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This article endeavours to explain the regulations and what advisers need to do to meet the regulations.

Regulations

It's all about ESG – Environmental, Social and Governance – helping improve ethical behaviour in how companies operate, and working towards improving climate change. The European Commission's Action Plan on Sustainable Finance is aimed at putting financial pressure on companies throughout the world to improve conditions for workers and to reduce their carbon emissions.

Sustainable Finance Disclosure Regulations (SFDR) effective on 10th March 2021

SFDR is mainly aimed at providers to supply sufficient information on their funds so that they can be classified under Article 6, 8 or 9 (See Table 1 Definitions on page 4). It requires asset managers to provide standardised disclosure on how ESG factors are integrated into their funds and products.

Further legislation – SFDR Level 2 RTS – will take effect from 1st January 2023 and will introduce more detailed requirements relating to disclosures in the periodic reports of ESG-focused products.

Insurance Distribution Directive (IDD) update 2nd August 2022

The IDD update aims to ensure that retail investors can invest sustainably and help facilitate the transition to a low-carbon, more sustainable, resource-efficient and circular economy in line with the Sustainable Development Goals.

Advisers have to recommend Insurance-Based Investment Products (IBIPs) that meet the sustainability preferences of their customers, if they have such preferences.

Advisers must update their advice process to take account of a customer's sustainability preferences and this applies to both New Business and Reviews where clients have money invested in funds.

EU Taxonomy

This is a classification system for business activities assessed under six environmental objectives – companies can be Taxonomy Non-Eligible / Taxonomy Eligible and/or Taxonomy Aligned or a combination.

Principal Adverse Impacts (PAIs)

These are negative, material, or potentially material effects on sustainability factors which result from, worsen, or are directly related to investment choices or advice performed by a legal entity.

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Understanding

The key terms in the legislation need to be understood by advisers so that they can clearly explain to clients why certain funds are recommended and others aren't. Once a client declares a preference for ESG funds, find out what level of sustainability preference the client has and then make appropriate recommendations. The aim is to avoid 'Greenwashing' – where some financial firms claim that their products are sustainable when they are not.

To determine clients' preferences, the adviser needs to have a clear understanding of the three different sustainability preference categories outlined in the IDD section of the table below.

SFDR	IDD
Article 6 Funds which do not integrate any kind of sustainability into the investment process.	**Choice 1** IBIPs where a minimum proportion is taxonomy aligned i.e. SFDR - investing in economic activities contributing to an environmental or social objective provided that the investment does not significantly harm any other environmental or social objective and that the investee companies follow good governance practices.
Article 8 Funds: – Which promote environmental or social characteristics or a mixture of both. – For which the underlying companies have good governance practices in place.	**Choice 2** IBIPs for which a minimum proportion shall be invested in sustainable activities according to SFDR.
Article 9 "A Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective."	**Choice 3** Which takes into account principal adverse impacts on the sustainability factors.

Under the IDD update that came into effect from 2nd August 2022, advisers have to gather the customer sustainability preferences when advising on insurance-based investments – **There is no Opt-Out to this requirement.**

Terms of Business/Website

These should clearly disclose whether the firm considers or does not consider the adverse impact of investment decisions on sustainability. Further Level 2 disclosures will come into force in January 2023 under the SFDR. The recently published Brokers Ireland Climate Guide has a good example of the wording required.

Practical Application for Advisers

The European Insurance and Occupational Pensions Authority (EIOPA) has published guidance to help intermediaries to integrate the new requirements on customers' sustainability preferences in the suitability test required under IDD.

The guidance provides a roadmap for firms, including **6 key actions** to ensure that their operational framework and due diligence process, and more specifically the so-called 'suitability test', are in line with the regulatory requirements for sustainability preferences.

01 **Include an explanation of 'sustainability preferences' in the interview with the customer** – The adviser should be able to explain the three sustainability preference choices.

02 **Redesign your suitability test** – The customer's sustainability preferences must be recorded by the adviser. The only exception to this principle is when the client clearly states their preferences at the beginning of the meeting.

03 **Include questions on sustainability preferences in your suitability test** – Assess the client's interest in sustainability and whether these should be considered in selecting suitable products/funds. If the client has no interest, then they are classed as 'sustainability neutral' and this should be recorded on the Factfind/Questionnaire and in the Suitability Letter. If the customer is interested in making a sustainability preference choice, the adviser will have to gather further information, based on the three sustainability aspects that an IBIP can have, broadly – (1) Taxonomy Aligned? (2) Sustainable Investment as per SFDR? Or (3) Consider PAIs? The client may choose one of these or a combination of two or all three and needs to decide minimum percentages or specific PAIs.

04 **Detail the client's sustainability preferences in the suitability statement** – Based on the client's sustainability preferences, the adviser may be able to select a suitable product or funds that match these. However, in some cases (e.g. where a client wants 100% Taxonomy-Aligned funds and none are available) this may not be possible and you have to ask the client if they want to adjust their preferences to widen the scope of available funds. This may mean revisiting the

Sustainability Questions and discussing alternative responses which increase investment choices.

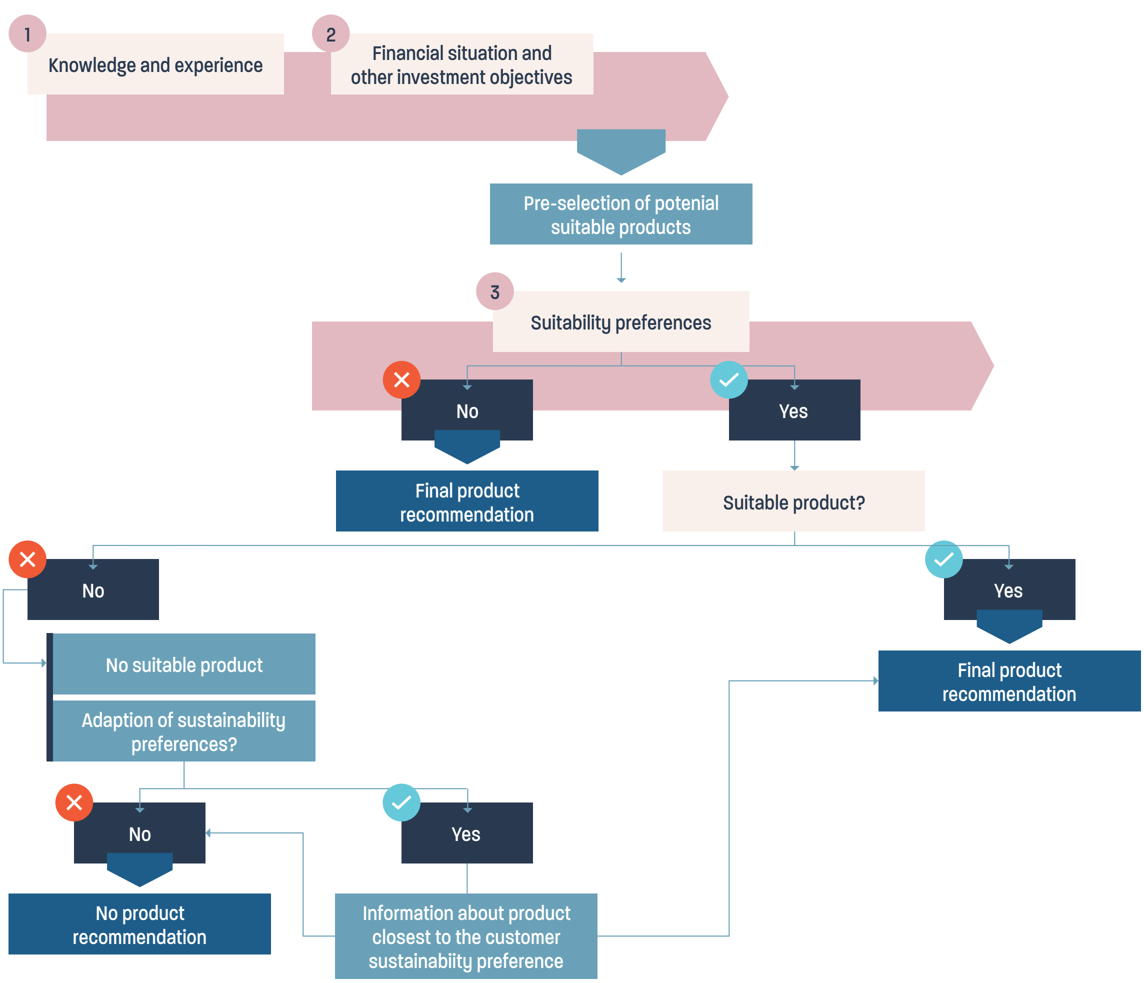
As of 1st January 2023, when the Commission Delegated Regulation (EU) 2022/1288 (8) will come into force, the adviser will have to ensure that the customer's sustainability preferences correspond to the precontractual information provided to them through the ESG standardised information document and the specific product information on the distributor's website. In this respect, particular attention should be paid to the possible choice of minimum proportions of each category provided by the client. Ideally, the adviser should have a matrix to classify all the products it distributes according to the various sustainability aspects included in its suitability assessment questionnaire.

An example decision tree below outlines this advice process:

05 **Include questions on sustainability preferences in the Annual Review** – Annual reviews have to take account of a client's sustainability preferences and any changes need to be recorded and, if necessary, the fund selection process should be reviewed to ensure that the client's investments are in accordance with their updated preference and recorded in a suitability statement.

06 **Train your Staff** – ensure the relevant employees (i.e. including persons in contact with the public and persons responsible for distribution) of intermediary distributing IBIPs (whether or not they are of a sustainable nature) are provided with basic knowledge and skills about sustainability preferences in their ongoing training.

Adapted Due Diligence Process



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Sustainability Preferences – Questionnaire

This set of questions can be integrated into your Risk Questionnaire, Factfind or as a separate ESG Questionnaire. You need to ask (1) if the client is interested in ESG investing (if not, this still needs to be recorded!) (2) if so, then which of the three categories or a combination of the three does the client prefer and (3) what minimum percentage is required/specific PAIs.

Suitability Statement

Depending on the client's responses, you will need to add wording to the Suitability Statement to cover the client's sustainability preferences.

(In the table below are example Terms of Business / Website)

Example Statements of Suitability Options		
Where a customer does not want their Sustainability Preferences Assessed.	Where a customer selects SFDR and/or Taxonomy Aligned funds.	Where a customer selects PAIs only.
You have chosen not to consider sustainability preferences when making your fund choice.	You have chosen to consider your sustainability preferences. However, you acknowledge that (PROVIDER) are not currently in a position to report on the proportion of any of their fund options which are invested in EU Taxonomy-Aligned investments or sustainable investments as defined by the SFDR. Therefore, you have adapted your sustainability preferences and this has been reflected in your fund choice.	You have chosen to consider your sustainability preferences and they have been reflected in your fund selections.
Your chosen investment funds risk ratings and sustainability classification are subject to change.		