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PEPP - REGULATION AND TECHNICAL STANDARDS FOR MARKET REALIZATION

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Адрес на редакцията:

София 1618

ул. „Гусла“ № 1 (кв. „Овча купел“)

Висше училище по застраховане и финанси

ст.308, тел. (02) 40 15 809

e-mail: pariikultura@vuzf.bg

www.vuzf.bg

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ESG FACTORS CONSIDERATION IN PEPP REGULATION

Michele Siri

Michele Siri, Jean Monnet Professor of European Union Financial and Insurance Markets Regulation at the University of Genoa and Director of the Jean Monnet Centre of Excellence EUSFIL. E-mail: michele.siri@unige.it

ABSTRACT

The consideration of ESG factors and risks in the context of PEPP Regulation coherently aligns with the recent EU regulatory initiatives on sustainable finance aimed at supporting the transition towards a carbon neutral economy and, in general, towards a more sustainable economic system. However, the uncomplete state of development of the sustainable finance regulatory reform poses many questions and challenges in relation to the implementation of ESG integration by PEPP providers.

KEYWORDS (max 5 parole): sustainable finance, PEPP regulation, ESG

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INTRODUCTION

In line with the EU recent efforts to concretely support the transition towards a carbon-neutral economy⁷⁷ and, in general, towards a more sustainable economic system by

⁷⁷ Commission, ‘The European Green Deal’, (Communication) COM(2019) 640 final. See Commission, ‘Proposal for a Regulation of the European Parliament and of the Council establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999’ (European Climate Law) COM(2020) 80 final. The Commission has presented (or plans to present) a number of related initiatives and action plans, including the above mentioned Industrial Strategy and the Circular Economy Strategy (‘A new Circular Economy Action Plan For a Cleaner and more competitive Europe’, Communication, COM/2020/98 final). For a road map, see the Annex to the Green Deal at https://ec.europa.eu/info/sites/info/files/european-green-deal-communication-annex-roadmap_en.pdf.

restructuring the entire EU financial regulatory framework,⁷⁸ Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (hereafter ‘PEPP Regulation’), includes many requirements concerning the integration of sustainability⁷⁹ - with particular reference to environmental, social and governance (ESG) concerns - in the investment processes, in line with climate objectives under the Paris Agreement⁸⁰ and the UN Sustainable Development Goals.⁸¹ Such integration is announced at Recital 8 of the Regulation, which expressly declares the intention to create “...a personal pension product which will have a long-term retirement nature and will take into account environmental, social and governance (ESG) factors as referred to in the United Nations – supported Principles for Responsible Investment...”.

Specific requirements concern, first of all, the disclosure of details of how the investment policy takes ESG factors into consideration, as well as ESG performance information, so complementing the disclosure requirements earlier introduced by the recent Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (‘Sustainability Disclosure Regulation’).

Further requirements concern the explicit consideration, by PEPP providers, of ESG-related risks and the long-term impact of investment decisions on ESG factors as part of their requirement to invest in line with the Prudent Person Principle.

The present paper provides a brief overview of the PEPP rules requiring the integration of ESG considerations, and investigates the main challenges posed to PEPP providers in the implementation of such rules.

⁷⁸ See M. Siri & S. Zhu, ‘Will the EU Commission Successfully Integrate Sustainability Risks and Factors in the Investor Protection Regime? A Research Agenda’, 11 (22) *Sustainability* (2019) 6292. See also D. Busch, ‘Sustainable Finance Disclosure in the EU Financial Sector’ (July 13, 2020), European Banking Institute Working Paper Series 2020 - n. 70, <https://ssrn.com/abstract=3650407>.

⁷⁹ Recitals 8, 43 and 47 and Article 2 Paragraph 33, Article 36 Paragraph 1.1, Article 35 Paragraph 6.c, Article 28 Paragraph 3.c (xii), and Article 377 Paragraph 1.c. of PEPP Regulation.

⁸⁰ UN. Paris Agreement on Climate Change. Framework Convention on Climate Change (12 December 2015).

⁸¹ UN General Assembly. Transforming our world: the 2030 Agenda for Sustainable Development, Resolution 70/1 adopted by the General Assembly (21 October 2015).

RESEARCH FINDINGS

ESG DISCLOSURE REQUIREMENTS

Differently from other EU sustainability-related texts - which refer to concepts such as ‘sustainability risks’⁸² and ‘sustainability factors’⁸³ – PEPP regulation curiously rather refers to ESG factors, defined as the “...environmental, social and governance matters such as those referred to in the Paris Agreement, the United Nations Sustainable Development Goals, the United Nations Guiding Principles on Business and Human Rights and the United Nations-supported Principles for Responsible Investment.” The direct and link to existing international principles and goals in the body of the regulation probably responds to the need to strengthen the alignment of the EU sustainability strategy with other global initiatives.

In relation to the above-defined ESG factors, PEPP Regulation requires PEPP providers to disclose a series of information, as listed below:

- a) A summary information on how the investment policy takes into account ESG factors in the context of the PEPP benefit statement, which should be drawn up to annually present PEPP savers with key personal and generic data about the PEPP and to ensure up-to-date information on it (Article 36, Paragraph 1.1 and Recital 43);
- b) Any change to the investment policy regarding the consideration of ESG factors in the investment policy (Article 35, Paragraph 6.c); and
- c) If available, the performance of the investments in terms of ESG factors in the context of the Key Information Document (‘PEPP KID’) (Article 28, Paragraph 3.c, xii).

Moreover, EIOPA’s Technical Advice published on August 2020 recommends the integration of ESG-related information in supervisory reporting.⁸⁴

In addition to such specific disclosure requirements, PEPP providers – as included in the concept of ‘financial markets participants’ together with portfolio managers, managers of

⁸²‘Sustainability risk’ is defined as “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”. See Article 2(22), Sustainability Disclosure Regulation.

⁸³ ‘Sustainability factors’ are defined as “environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters”. See Article 2(24), Sustainability Disclosure Regulation.

⁸⁴ EIOPA, Technical Advice on delegated acts supplementing Regulation (EU) 2019/1238 (the PEPP Regulation) by specifying additional information regarding supervisory reporting, EIOPA-20-502, 14/08/2020.

UCITS, AIF or EuVEC/EuSEF, IORP and pension product manufacturer – ⁸⁵ should also comply with some general rules introduced by the recent Sustainability Disclosure Regulation. Such Regulation – aimed at avoiding green-washing practices and strengthening informed decision-making by end-investors when buying products marketed as sustainable investments – requires financial institutions to disclose procedures on integrating ESG risks in the investment process, the extent to which these risks impact the investment performance and the non-financial impact of investments on ESG factors. Specifically, the Sustainability Disclosure Regulation – which will become effective in Q1 2021 – requires financial market participants to a) publish on their websites and include in pre-contractual documents information on their policies on integrating sustainability risks in the investment decision-making process (Artt. 3 and 6), (b) publish and maintain on their websites information concerning whether (and if not, why) they take into account ‘principal adverse impacts of investment decisions on sustainability factors’ at the entity and product level (Art. 4, 7); (c) include in their remuneration policies information on the integration of sustainability risks (Art. 5); and (e) for products marketed as sustainable based on their ESG characteristics or objectives, information on how such characteristics or objectives are met and if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. Moreover, according to Articles 6-7 of Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment (‘Taxonomy Regulation’), in the event a product does not qualify as ‘sustainable investment’, pre-contractual disclosure and periodic reports must contain a disclaimer warning that the investments underlying this financial product do not take into account or only partially takes into account the EU criteria for environmentally sustainable economic activities.

However, notwithstanding the potentially strong impact performed by the introduction of these measures, the implementation of such rules will undoubtedly encounter many challenges, based on the still uncomplete state of development of the sustainable finance regulatory reform. In particular, the applicability of the abovementioned regulations before final Level 2 measures are even adopted – with particular reference to an official green taxonomy – has already generated confusion and fears among financial institutions.⁸⁶ Moreover, the effective disclosure,

⁸⁵ Article 2 Paragraph 1.f of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

⁸⁶ See AFME, AIMA, AMICE, EACB, EBF, EFAMA, ‘Application date of the Regulation on sustainability disclosures – Letter to the European Commission’, (16 September 2019), <https://insuranceeurope.eu/sites/default/files/attachments/Joint%20letter%20on%20regulation%20on%20sustainability%20disclosures.pdf>; Securities and Markets Stakeholder Group (SMSG), ‘Advice to ESMA (ESMA

by financial market participants, of information on the integration of ESG factors in their investment processes inevitably depends on the availability of reliable data concerning the ESG performance of companies, data which has been found still lacking by empirical research,⁸⁷ even after the introduction of Directive 2014/95/EU on disclosure of non-financial and diversity information ('Non-Financial Reporting Directive').⁸⁸ To respond to such need, the Commission is considering reforming the Non-Financial Reporting Directive, and a public consultation was launched on 20 February 2020.⁸⁹

However, the potential timing misalignment among the several regulatory measures still remains a relevant issue in the implementation of both PEPP Regulation and Sustainability Disclosure Regulation.

THE INTEGRATION OF ESG FACTORS IN THE PRUDENT PERSON PRINCIPLE

According to the Prudent Person Principle (PPP), PEPP providers should act prudently and in the best long-term interests of PEPP savers.⁹⁰ This means that PEPP providers generally should: (a) invest in the best long-term interests of PEPP savers as a whole, (b) invest in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole, (c) invest predominantly on regulated markets, (d) make investments in derivative instruments on a prudent basis, (e) properly diversify the assets, (e) not invest in a non-cooperative

Consultation Papers on integrating sustainability risks and factors in MIFID, the UCITS Directive and AIFMD', (6 March 2019).

⁸⁷ Non-financial statements have been said to be generally affected by lack of quantitative disclosure, lack of clarity concerning the selection and measurability of non-financial targets, but also that they are over-generic, they do not appropriately address climate-related risks nor provide sufficient descriptions of due diligence processes, especially related to human rights and social matters. See ESMA, Report Enforcement and regulatory activities of European enforcers in 2019 (April 2020) and Alliance for Corporate Transparency, 2019 Research Report: An analysis of the sustainability reports of 1000 companies pursuant to the EU Non-Financial Reporting Directive (February 2020).

⁸⁸ Such directive requires that certain large companies disclose information about their due diligence processes and policies in relation to environmental, social and employee matters, respect of human rights, anti-corruption and bribery issues, and diversity on company boards (in terms of age, gender, educational and professional background). See Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups. See also European Commission, Guidelines on non-financial reporting 2017/C 215/01, and European Commission, Guidelines on Non-Financial Reporting: Supplement on Reporting Climate-Related Information, C (2019) 4490 Final (17 June 2019).

⁸⁹ See Commission, 'Consultation strategy for the revision of the Non-Financial Reporting Directive – Background document' (20 February 2020), <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation>. See also EU Commission, Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive, Ares(2020)3997889 - 29/07/2020, available at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation>.

⁹⁰ Recital 46 of PEPP Regulation.

jurisdiction for tax purposes, and (f) not expose themselves and the assets corresponding to the PEPP to risks stemming from excessive leverage and excessive maturity transformation (Article 41, 1. a, c, d, e, f, g, h).

In addition to such rules, PEPP Regulation demands the integration of ESG considerations by requiring that PEPP providers should “take into account risks related to and the potential long-term impact of investment decisions on ESG factors” (Art. 41, 1.b).⁹¹

Such requirement recalls EU Commission proposal to consider sustainability concerns in the prudent person principle for investments under the Solvency II regime.⁹² In its Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD issued on 30 April 2019 (‘Technical Advice’), EIOPA recommends that, on the one hand, undertakings should take into account sustainability risks, especially climate-related risks, so to act in the best interest of the policyholders and beneficiaries in line with the PPP, and, on the other, that undertakings should assess the potential long-term impact of their investments on sustainability factors (performing, for instance, active engagement strategies). However EIOPA also specifies that does not means “requiring undertakings to make sustainable investments or to invest with impact, or to accept lower risk-adjusted returns” as they “may decide on their stewardship approach by exercising voting rights for equity holdings, but also by implementing or adapting investment strategies e.g. for best-in-class investments or exclusion”.⁹³ Such recommendations have been included in the Commission Delegated Regulation (EU) amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, which introduced Article 275a on the integration of sustainability risks in the prudent person principle.

While the integration of sustainability considerations in Solvency II represented one of the main issues on which EIOPA focused its attention in its Technical Advice, on the contrary, the integration of ESG risks and factors in the context of PEPP has not still received much attention. As a consequence, financial market participants asked for further clarification by the EU institutions, and future guidance is expected.⁹⁴

CONCLUSION

⁹¹ See also Recital 47 of PEPP Regulation that requires that the PPP “should also take into explicit consideration the role played by ESG factors in the investment process”.

⁹² Commission Delegated Regulation (EU) amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.

⁹³ EIOPA’s Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, EIOPA-BoS-19/172 30 April 2019, §115.

⁹⁴ See, for instance, PRI, Policy Briefing: EU Regulation on A Pan-European Personal Pension Product (2019).

The present paper briefly described the recently introduced rules concerning the integration of ESG consideration in the context of PEPP Regulation, highlighting challenges and uncertainties to be faced by PEPP in the implementation.

Notwithstanding such integration coherently aligns with other recent financial regulatory reforms enacted or planned to be enacted by the EU legislator, the still incomplete state of development of the sustainable financial regulatory reform – with particular reference to the finalization of an official green taxonomy -, as well as the lack of reliable ESG data reported by companies, and the need for further clarification in relation to the integration of ESG consideration in the context of the Prudent Person Principle, has already generated perplexity and confusion by financial market participants and further guidance by the EU institutions is expected.

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