

Product Governance and Sustainability

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With new regulations around sustainable finance measures now in force, credit institutions, investment firms, and insurance undertakings who manufacture, and distribute, financial products have to integrate new sustainability factors into their suitability assessments and product governance arrangements. The purpose of product governance is to ensure that firms that manufacture financial instruments and distribute financial instruments or services act in the clients' best interests during the life-cycle of the product or service.

Product Governance Requirements for Manufacturers

Credit Institutions and Investment Firms

Under the previous iteration of the Markets in Financial Instruments Directive II (MIFID II) credit institutions and investment firms were required while designing financial instrument products to consider factors such as; client type, client objectives, client knowledge, product innovation, product complexity, risk reward profile, and liquidity profile of the potential target market. There was however, no requirement to give consideration to sustainability preferences of the target market. Under the new Environmental Social & Governance (ESG) amendments to MIFID II, firms are required, from 22 November 2022, to determine that the product's sustainability factors are consistent with the target market's needs, characteristics, and objectives. Firms should ensure that sustainability is integrated into their overall strategy as this will increase the likelihood that products meet customers' preferences.

Firms should regularly conduct reviews of the financial instruments' sustainability factors so as to ensure they continue to remain consistent with the needs, characteristics and objectives, and sustainability preferences of the target market. This can be achieved by illustrating in suitability reports how services provided meet clients' expressed sustainability preference.

The ESG amendments to sustainability preferences fall into three categories:

1. Environmentally sustainable investments allow customers to purchase a product where a set proportion of the investment is allocated to investments that are environmentally sustainable. This type of investment would need to qualify as an environmentally sustainable product under the requirements set out in Article III Taxonomy Regulation.
2. Sustainable investments are products which pursue a minimum proportion of sustainable investments.
3. The customer in this instance determines the minimum proportion that is allocated to the sustainable investment. Investments that consider sustainability factors are products that are designed to consider principal adverse impacts on sustainability factors, where elements which demonstrate that consideration are determined by the customer.

When selecting a distribution channel, firms who manufacture products must take appropriate measures to ensure that the financial product is distributed to the target market. The distribution strategy must take steps to choose a distributor whose customer base and services are aligned with the target market. Firms must provide their distribution partners with relevant and transparent information which considers any sustainability-related objectives of the target market. Manufacturers should also communicate the preferred distribution method to distributors, e.g. the manufacturer has designed a product that is best suited to being sold face to face.

Insurance Undertakings

The ESG changes to the Insurance Distribution Directive (IDD) are very similar to the MIFID II changes outlined above. Both life insurers and non-life insurers are required to embed sustainability objectives and factors while identifying target markets. Sustainability objectives must be integrated into the product approval process and staff who are involved in product design and development must have the requisite skills knowledge and experience.

With regards to insurance-based investment products, IDD has been amended in such a way that requires manufacturers to follow the same three sustainability categories noted above i.e. environmentally sustainable investments, sustainable investments, and investments that consider sustainability factors.

For non-life insurers the requirements of the investment element is not included given the nature of non-life products.

Product Governance Requirements for Distributors

Distributors must complete a similar target market assessment to that outlined above to ensure that the product or service is compatible with the needs, characteristics, and objectives of their clients. Since August 2022, distributors have been subject to an obligation to gather the sustainability preferences of clients, either at onboarding or on an ongoing basis, and to consider these as part of the suitability assessment process. At this point, firms will have:

- Completed updates to their processes and procedural documentation to include sustainability related objectives in the target market assessment and annual reviews.
- No longer identify a negative target market for financial instruments that consider sustainability factors, these will be positive or neutral.
- Updated the product review process to include sustainability related objectives of the target market.

- Familiarised themselves with the revised product information and target market data, including sustainability related objectives and sustainability factors, received from manufacturers. Manufacturers will provide this information to distributors via the European ESG template (EET).

“Sustainability related objectives” is not defined in the new regulation. As such, firms will need to complete their own interpretation of what this means in practice. Distributors may have instructions from clients that they wish to have a minimum proportion of their portfolios invested in sustainable investments, or they may have specific ESG goals that they wish to focus on, e.g. invest in funds that have express objectives regarding climate change mitigation. The firm will need to review the client portfolio periodically to ensure that the client’s objectives are being met and proactively manage situations where changes to product ESG credentials lead to the portfolio no longer meeting the client’s expressed sustainability related objectives.

In addition to the Delegated Act, the European Securities and Markets Authority (ESMA) issued a consultation relating to their existing Guidelines on Product Governance, which closed on 07 October. They plan to publish the final report and guidelines in Q1 2023. The proposed changes take into account the sustainability related amendments to the MiFID II Delegated Directive, along with the findings of ESMA’s Common Supervisory Action on product governance and recommendations on product governance issued by ESMA’s Advisory Committee on Proportionality.

