2021

Assessment of the Sustainable Finance Disclosure Regulation Article 3 in the Danish Financial Sector

1. Summary

The Danish Financial Supervisory Authority (hereinafter the "DFSA") has reviewed the compliance of 12 banks and pension funds with the disclosure obligation under Article 3 of the Sustainable Finance Disclosure Regulation (hereinafter the "SFDR"), which entered into force on 10 March 2021. These are the first reviews of the implementation of the SFDR conducted by the DFSA.

According to Article 3, financial market participants and financial advisors shall publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making processes and investment or insurance advice. Sustainability risks are, in the sense of the SFDR, ESG-related events or conditions that, if they occur, could cause an actual or a potential material negative impact on the value of an investment. The purpose of the provision is thus to inform end-investors about how undertakings in their processes integrate and continuously assess not only all relevant financial risks, but also all sustainability risks that could have a relevant material negative impact on the value of an investment.

The result of the reviews shows that several of the reviewed undertakings have implemented the obligations under Article 3 insufficiently. The DFSA will however not apply supervisory reactions since this is a new legislative area. Instead, the reviewed undertakings will receive individual feedback and elaborations on their shortcomings from the DFSA.

2. Background on the reviews

On 26 May 2021, the DFSA initiated two reviews of the compliance of selected banks and pension funds with the disclosure obligations pursuant to Article 3 of the SFDR (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).

Both reviews are described in this note, since they are parallel reviews examining the same provisions, albeit in two different areas of the financial sector.

1.1 What has the DFSA reviewed?

The SFDR entered into force on 10 March 2021 and contains several disclosure obligations for financial market participants and financial advisers regarding environmental, social and governance aspects (i.e. sustainability factors or ESG factors).

These reviews have two purposes: 1) to examine whether selected banks and pension funds comply with the requirements of Article 3 of the SFDR and 2) to identify best practice in the field, to the extent possible, by comparing how banks and pension funds meet the obligations of Article 3.

In this regard, it should be noted that the provisions of Article 3 of the SFDR are not related to the regulatory technical standards of the SFDR, which have not entered into force.

1.2 Which undertakings has the DFSA reviewed?

The DFSA has reviewed selected banks and pension funds covered by the scope of the SFDR, cf. Article 2, no. 1, letters d and j, and Article 2, no. 11, letter c, respectively.
Based on a risk-based approach, the DFSA has conducted a selection of undertakings from the two sectors. More specifically, eight banks and four pension funds were selected for the review, which was conducted off-site based on documentation provided by the respective selected undertakings.

3. Article 3 of the SFDR

Article 3 of the SFDR sets out requirements for transparency in sustainability risk policies.

Article 3 states that

1. *Financial market participants shall publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making process.*
2. *Financial advisors shall publish on their websites information about their policies on the integration of sustainability risks in their investment advice or insurance advisory process.*

The article thus sets out transparency obligations, which apply 1) to specific types of undertakings (i.e. financial market participants and financial advisers), 2) regarding specific information (i.e. integration of sustainability risks) and 3) shall be published in a specific way (i.e. on the websites of the undertakings). The requirements are reviewed in the following subsections.

2.1 Scope of requirements: financial market participants and financial advisers, respectively

As stated in Article 3, the provisions impose disclosure obligations on two types of undertakings, namely financial market participants and financial advisers. These are defined in Article 2 (1) and (11) of the SFDR:

- Financial market participants include i.a. "A manufacturer of a pension product" and "a credit institution which provides portfolio management", cf. Article 2 (1) (d) and (j).
- Financial advisers include "A credit institution which provides investment advice", in accordance with Article 2 (11) (c).

Further, preamble 7 of the SFDR states that an entity covered by the regulation, which acts in both the role of financial market participant and financial adviser, in accordance with the definition above, shall comply with the disclosure obligations for both business areas.

2.2 Sustainability risks equal financial risks

Article 3 of the SFDR requires undertakings to publish information about their policies on the integration sustainability risks. A 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” cf. Article 2 (22) of the SFDR.

Thus, as stated in preamble 12, financial market participants and financial advisers shall inform end investors about the integration and continuous assessment in their processes of all relevant financial risks, including sustainability risks, that might have a relevant material negative impact on the financial return of an investment or advice.

In a sustainability context, a distinction can thus be made between the above-mentioned sustainability risks, to which *undertakings are exposed*, and, on the other hand, the *impact of undertakings* on sustainability factors:

- **Sustainability risks.** Sustainability factors that can negatively impact the value of the investments of undertakings, and thus the investments of their customers.

- **Impact on sustainability factors.** The impact of undertakings on sustainability factors, i.e. environmental, social and governance matters.

Article 3 of the SFDR sets out disclosure obligations regarding policies on the integration of *sustainability risks. Thus,* information about objectives for *impact on sustainability factors* are only relevant to the policies required in Article 3, insofar as these objectives are linked to sustainability-related financial risks.

2.3 Different types of sustainability factors

Sustainability factors are a collective term for sustainability-related factors that can affect the value of an investment. This section outlines three such types, namely financial risks, social factors and governance-related factors.

The financial risks of environmental degradation and climate change can be divided into two categories: physical risks and transition risks. *Physical risks* comprise sudden and extreme weather events (e.g. heat waves, floods, fires and storms), persistent climate change (e.g. changes in precipitation, rising water levels and rising average temperatures), loss of eco-systems (e.g. desertification, water scarcity, deterioration of soil quality or marine ecosys-tems) or environmental events (e.g. oil or chemical spills to land, water or air). These condi-tions may have a negative impact on the market value of directly owned physical assets (e.g. real estate) as well as on financial assets.
Transition risks arise in the attempt to address environmental and climate-related challenges, (e.g. in the transition to a CO2-neutral economy). They include developments in regulation, technology changes, new business models and changes in consumer behaviour. These de-velopments could have a negative impact on the liquidity and market value of investments (e.g. in sectors with high CO_2-emissions).
Both physical risks and transition risks imply a risk of "stranded assets".

Social factors comprise exposures to activities that may be adversely affected by problematic social conditions (e.g. human rights violations, poor working conditions, child labour, health issues, inequality and discrimination).

Governance-related factors comprise exposures to activities that may be adversely affected by staffing or management conditions (e.g. corruption, bribery, conflicts of interest and tax matters).

2.4 Requirements regarding transparency and timeliness of the information

The SFDR neither sets out formal requirements on how the policies shall be formulated nor specifically where on the websites of the undertakings the information shall be located. However, Article 3 presupposes that undertakings publish at least one text, which creates transparency regarding their integration of sustainability risks. This information shall thus provide investors with an understanding of how the undertakings work with sustainability risks or alternatively why they refrain from doing so.

In addition, Article 12 of the SFDR requires financial market participants and financial advisers to keep the policy *up to date* on their website. Specifically, Article 12 requires financial market participants and financial advisers to: (i) provide a clear explanation of the amendments of information published in the policy and (ii) publish this explanation on their website.

3. Analysis

This section presents the DFSA's analysis of the documents provided by the selected undertakings. The first part of the analysis looks into the policies and examines whether the content meets the requirements of Article 3 of the SFDR. The second part examines the compliance with the publication requirement of the article, i.e. on the websites of the undertakings. The third part examines the extent to which the policies are implemented in the internal processes of the undertakings. Finally, the DFSA draws a conclusion on the key issues.

3.1 Do undertakings describe how sustainability risks are integrated?

As mentioned, Article 3 requires undertakings to provide end-investors with information on how sustainability risks are integrated, as defined in Article 2 (22). In other words, the objective of the article is to create transparency and provide end-investors with information on how undertaking deals with sustainability risks and asses their significance, respectively, cf. preamble 23.

All the reviewed undertakings state that they integrate sustainability risks in their investment decision-making process or advice. However, the level of detail in the descriptions of this integration vary significantly and can be divided into three categories.

The DFSA finds that two of the reviewed undertakings apply broad and general descriptions of how sustainability risks are integrated in their investment decision-making processes or advice. For example, with a policy which either states that sustainability risks are integrated in *all* investment decision-making processes of the undertaking, or that the integration of such risks is carried out differently depending on the specific investment without further specifications. Such general descriptions do not provide customers with a proper understanding of where and how the undertaking takes these risks into account, which is a very key element of the disclosure obligation in Article 3.

Furthermore, the DFSA assesses that eight of the reviewed undertakings apply more specific descriptions of certain parts of the investment decision-making process or the advisory process, e.g. through descriptions of the processes of the undertaking pertaining to fund screenings or active ownership. However, this group of undertakings only describes certain elements of these processes, and as a consequence, customers are not provided with a coherent understanding of the specific management of these risks.

Finally, the DFSA finds that only two of the reviewed undertakings provide a more nuanced description of where and how the undertaking integrates sustainability risks across its investment area or advice, and thereby provide end-investors with proper information pertaining to when and how in the investment decision process or advice the undertaking mitigates these risks. The DFSA assesses that such descriptions are essential for complying with the transparency objectives regarding the integration of sustainability risks of the regulation.

3.1.1 The DFSA's comments

Based on the wording of Article 3 of the SFDR and the documents provided by the reviewed undertakings, the DFSA assesses that the most useful and comprehensive Article 3 policies clearly address *where* and *how* the undertaking integrates sustainability risks in investment decision-making processes or investment or insurance advice.

This includes nuanced and concrete descriptions of the actions applied to minimise sustainability risks carried out by the undertakings in investment decision-making processes or investment or insurance advice, or alternatively the *lack* of such actions, such that the end-investor is properly informed about where and how, specifically, the undertaking takes the identified risks into account.

To this end, the DFSA assesses that descriptions of how undertakings generally take sustainability risks into account in their investment decision-making processes or advice without any concrete specifications do not provide end-investor with proper transparency regarding the management of these risks by the undertakings.

3.2 Do undertakings describe their assessment of the impact of sustainability risks on the value of their investments?

Sustainability risks are, as explained in section 2.2, factors that can negatively impact the value of an investment. Undertakings must be transparent about what they see as sustainability risks in order to manage such risks. As stated in preamble 12, integration of sustainability risks entails assessment on a continuous basis of how such risks affect the value of an investment.

Thus, the reviewed undertakings comply with Article 3 only in cases where their policies as a minimum include considerations as to whether sustainability factors can have a negative impact on the value of the specific investments of the undertaking.

The reviewed undertakings neither comply with Article 3 in cases where the policy only contains information on the considerations of the undertaking pertaining to the impact of its investment decisions on sustainability factors, nor in cases where the policy gives the impression that the undertaking only includes sustainability considerations in the investment and advisory processes for reasons other than financial, e.g. for reasons pertaining to social responsibility or ethics. In these cases, the policy will thus not cover sustainability risks in the understanding of the SFDR, cf. section 2.2 above.

First, the DFSA assesses that four of the reviewed undertakings do not have a policy that describes their assessment of sustainability risks, which can have a relevant material negative impact on the value of an investment. Thus, these undertakings do not meet the obligations of Article 3.

Second, the DFSA assesses that six of the reviewed undertakings do not assess the sustainability risks to which their activities are exposed in a sufficiently nuanced and specific way. Rather, these undertakings either apply generic descriptions of what sustainability risks entail, e.g. some merely reproduce the definition from Article 2 (22), or apply other forms of superficial, vague descriptions accompanied by a few examples of such risks. This does not provide customers with proper information about the specific sustainability risks faced by the undertaking.

Finally, only two of the reviewed undertakings describe in a more nuanced way the impact of sustainability risk on the value of their specific exposures, e.g. by assessing the presence of different types of sustainability risks across the different types of investments in which undertakings are involved or by assessing to which risks they are most exposed, as well as the likelihood of these risks occurring. This provides the customer with a concrete knowledge of the sustainability risks faced by the given undertaking, and thus contributes to fulfilling the transparency objectives of the regulation.

3.2.1 The DFSA's comments

The DFSA assesses that the most useful and comprehensive Article 3 policies clearly address whether sustainability risks may have a negative impact on the value of the specific investment of the undertaking as defined in Article 2, no. 22 of the SFDR.

This implies nuanced and entity-specific assessments of how different sustainability risks are managed across the given types of investments of the undertaking, thus providing end-investors with proper information regarding the exposures of the undertaking.

To this end, generic and general descriptions of sustainability risks as a phenomenon, are not sufficient for complying with the transparency objectives of the SFDR.

3.3 Which documents include the sustainability risk integration policy?

All the reviewed undertakings have provided more than one document to the DFSA in connection with the review and have specified that several of these documents form the basis of their policy for integration of sustainability risks. In the vast majority of cases, the reviewed undertakings include definitions of sustainability risks and their policy for integration of these in one single document.

The remaining documents provided by the undertakingsin connection with the review, describe policies regarding responsibility and impact objectives as regards to sustainability factors. These policies are poorly linked to the impact of sustainability risks on the value of an investment, as defined in the SFDR.

3.3.1 The DFSA's comments

DFSA assesses that it is not sufficiently clear in all cases how and whether the mentioned processes are intended to manage sustainability risks in line with the obligations of the SFDR, since the information only vaguely indicates how the undertaking manages environmental, social or governance events or conditions which, if they occur, could cause an actual or a potentially material negative impact on the value of an investment.

Rather, in several cases it appears that the primary purpose of the submitted policy stems from the desire of the undertaking to contribute to sustainability factors, including through ESG and climate objectives. However, such information is only relevant to the requirements of Article 3 insofar as it is linked to sustainability-related financial risks. Namely, the purpose of Article 3 is the provision of proper information to end-investors pertaining to the management of sustainability risks of the undertaking.

This indicates an insufficient conceptual distinction between *sustainability risks* and *impact on sustainability factors,* respectively, as well as an insufficient understanding of the fact that Article 3 pertains exclusively to sustainability risks, i.e. negative impact of sustainability factors on the value of an investment.

Further, the policy for integration of sustainability risks shall be easily accessible and identifiable to the end-investors. The DFSA assesses that this obligation can be met in an appropriate manner through the publication of either an independent policy on the integration of sustainability risks or through an independent section with a telling title in a broader policy on the area.

3.4 How do the undertakings comply with the publication requirement?

According to Article 3, policies on the integration of sustainability risks shall be published on the websites of the undertakings. Therefore, the DFSA requested the reviewed undertakings to submit website links to the specific location of their Article 3 policy.

At the time of the review, 11 out of the 12 reviewed undertakings submitted such a website link. Thus, one of the undertakings did not comply with this requirement of Article 3.

Further, the DFSA has examined the accessibility of this information on the websites of the reviewed undertakings, in the light of the objectives of the SFDR regarding provision of sustainability information to end-investor.

Article 3 does not set out specific requirements regarding the specific location on the website of the policies on the integration of sustainability risks. Therefore, it is not surprising that the reviewed undertakings locate these policies on different types of subpages of their website.

However, the majority of undertakings, which have published the policies on their website (6 out of 11), have located the policy on a subpage with "sustainability" in the title.

3.4.1 The DFSA's comments

The DFSA expects that undertakings have published policies on the integration of sustainability risks on their websites, as required in Article 3 of the SFDR of 10 March 2021.

Furthermore, the DFSA assesses that these policies should be published in a logical and easily accessible location on the websites of the undertakings, in order to facilitate their identification by the end-investor.

3.5 Do the undertakings apply the policies in their internal processes?

The DFSA considers it to be essential that undertakings comply with their policies on the integration of sustainability risks in their investment decision-making processes and advice, i.e. that these policies do not merely serve as declarations of intent. The policies shall address the integration of sustainability risks in investment decision process and advice, i.e. sustainability risks shall be integrated in the core business, which emphasises the importance of acting in accordance with the policies.

Therefore, the DFSA asked the reviewed undertakings to submit a description of how the policies in question are applied in their internal processes as well as to submit relevant documents in connection thereto in order for the DFSA to examine whether the undertakings comply with these policies.

The DFSA finds that the undertakings reply to this request in different ways. Some of the undertakings refer to their website or to the policy without further explanation. Others describe on a general level how they apply the policy in their daily internal processes or provide concrete examples of this. Some undertakings refer to a submitted business process for their internal processes pertaining to integration of sustainability risks in investment processes, while a final group of undertakings state that a body of the undertaking is focal point for, among other things, managing and deciding the content of the policies.

3.5.1 The DFSA's comments

The DFSA emphasises the fact that proper compliance with the Article 3 policy is a necessary and essential prerequisite for ensuring transparency pertaining to the integration of sustainability risks in the investment decision-making process and investment or insurance advice.

The DFSA expects that the internal processes of the financial market participants and the financial advisers comply with the policies on the integration of sustainability risks. Thus, it is crucial that the content of the policy is implemented in the investment decision-making processes of the financial market participant and in the investment or insurance advice of the financial adviser.

The DFSA does not have sufficient documentation based on the present review to form an overall opinion of this issue. The DFSA will focus on this area in future supervisory efforts.

4. Conclusion

The DFSA has conducted two reviews on the implementation of Article 3 of the SFDR among a number of banks and pension funds. The DFSA finds significant room for improvement among the reviewed undertakings on several points, particularly as regards to more nuanced identifications of sustainability risks for the given investments of the undertakings as well as where and how specifically these risks are integrated into the investment decision process or investment advice.

In summary, the DFSA assesses that the most comprehensive Article 3 policies:

- Clearly assess sustainability risks as defined in Article 2 (22) of the SFDR.
- Assess in a nuanced and entity-specific way how different sustainability risks apply across the types of investments of the given undertaking, so the end-investor is provided with a full picture of the exposures of the undertaking.
- Describe where and how sustainability risks are integrated in investment decision-making processes or investment or insurance advice, so the end-investor is informed about how specifically the undertaking manages the identified risks.
- Are easily accessible on the websites of the undertakings either in the form of an stand-alone policy on the integration of sustainability risks or as a clearly defined section pertaining to the integration of sustainability risks in a more general policy on the area.
- Finally, it is crucial that the content of the policy is actually implemented in the investment decision-making processes of the financial market participant and when the financial adviser provides investment or insurance advice.

The DFSA will also be focusing on the themes above in future supervisory efforts.