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REPORT

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Thematic review on sustainability-related information in remuneration policies

1. Summary

The Danish Financial Supervisory Authority (DFSA) has investigated the information in the remuneration policy of six selected pension companies and life insurance undertakings on the relation between remuneration and the integration of sustainability risks. The obligation to disclose this information follows from article 5 of the Sustainable Finance Disclosure Regulation (SFDR).[1]

The main purpose of article 5 in the SFDR is to provide greater transparency for customers and investors on how the undertakings' remuneration structure ensures an appropriate management of sustainability risks and does not promote excessive risk taking. The SFDR does not regulate the undertakings' possibility of granting variable remuneration.

The SFDR entails that financial market participants and financial advisers are required to distinguish between sustainability *impact* and sustainability *risk* in their information to end-investors and customers. The former relates to the undertakings' impact on environmental, social and governance (ESG) issues in society, whereas the latter is about how ESG issues may potentially have an effect on the value of the undertakings' investments.

ESG issues, including climate change and environmental deterioration, are sources of financial risks.[2] It is therefore decisive that the financial undertakings ensure transparency in respect of whether and, if so, how they through the remuneration policy promote sound management of sustainability risks in their investment decision-making process and investment or insurance advice.

[1] 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

[2] The Danish FSA has previously issued a memorandum describing, among other things, how climate changes may manifest themselves as financial risks: DFSA paper on climate change and sustainable finance in the financial sector

The SFDR does not require financial undertakings to establish a connection between the undertakings' remuneration and their integration of sustainability risks. However, it requires the undertakings to disclose whether there is a connection, and if so, describe this connection.

The DFSA's review showed that the majority of the undertakings had not provided adequate information on how their remuneration policy is consistent with the undertaking's integration of sustainability risks. The DFSA in particular found that the undertakings often disclose whether there is a connection, but not *how* they ensure this connection.

The review also showed that several undertakings in their disclosures do not distinguish clearly between, on the one hand, how their remuneration policy seeks to contribute to the undertaking's sustainability objectives and, on the other hand, how it seeks to enhance the management of sustainability risks in its investment processes. Moreover, some of the undertakings, which have disclosed information on sustainability risks in their remuneration policy, could not sufficiently prove that they comply with the published information.

As a result of the review, the DFSA has issued orders for insufficient disclosures to four of the six financial undertakings that were selected for the review.

Based on the review, the DFSA finds that it is important that financial undertakings in scope of the SFDR ensure:

- that the remuneration policy contains information on how the remuneration is in accordance with integration of sustainability *risks*, where sustainability risks are to be understood as financial risks, and that this information is published on the undertaking's website;
- that the remuneration policy describes, not only whether, but also *how* the remuneration policy is consistent with the undertaking's integration of sustainability risks. This entails that undertakings, which state that the remuneration policy is in accordance with the integration of sustainability risks, have to elaborate on how sustainability risks is considered as an element in variable remuneration schemes, etc.;
- that the undertakings comply with the information provided in their policy and that this can be proved.

This report summarises the main observations from the review and lays out the DFSA's expectations for good practice in the area.

2. Background

2.1 Scope of the review

In April 2022, the DFSA initiated a thematic review of compliance with article 5 of the SFDR.

The review comprised six pension companies and life insurance undertakings, which are covered by the SFDR according to article 2(1), (c) and (d) of that regulation. The review was carried out on the basis of material collected from the selected undertakings.

The DFSA investigated whether the undertakings had included sufficient information in their remuneration policies and whether the information had been published on the undertakings' websites. The DFSA also considered whether the undertakings were able to prove that they complied with the information provided in the remuneration policy.

2.1 Article 5 in the disclosure regulation

The SFDR contains a number of provisions, which require financial market participants and financial advisers to publish sustainability-related information about their undertaking and their products. Article 5 relates to the remuneration policies of the undertakings.

Article 5 states that:

1. *Financial market participants and financial advisers shall include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and shall publish that information on their websites.*
2. *The information referred to in paragraph 1 shall be included in remuneration policies that financial market participants and financial advisers are required to establish and maintain in accordance with sectoral legislation (…)*.

Article 5 of the SFDR thus adds a disclosure requirement to existing remuneration policies. The financial undertaking must include information in its remuneration policy on how the undertaking's remuneration structure is consistent with the undertaking's integration of sustainability risks.

The provision does not oblige the undertakings to create a connection between the undertakings' remuneration structure and the integration of sustainability risks. But it requires the undertakings to disclose whether and, if so, how there is a connection.

The SFDR defines sustainability risks as '*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). As such, a sustainability risk is a financial risk to which the undertaking and its customers/investors are exposed.

'Integration of sustainability risks' must be understood as the way in which the undertaking works with sustainability risks in relation to the undertaking's investment decision-making processes and/or investment or insurance advice. This includes processes, methods, tools, etc. used by the undertaking to identify, prioritise and handle ESG-related financial risks.

The undertakings must maintain a policy for integration of sustainability risks, which describes these processes, cf. article 3 of the SFDR. This policy was previously subject to a thematic review by the DFSA.[3]

According to article 5, the remuneration policy must therefore describe the relation between the undertaking's integration of sustainability risks and the undertaking's granting of variable remuneration. As an example, the remuneration policy could contain information that the undertaking when granting variable remuneration takes into consideration whether the employee in question has complied with policies for integration of sustainability risks in investment decision processes. Such processes could involve, for instance, carrying out ESG due diligence prior to an investment decision. Non-compliance with the policy could, as an example, result in a reduction of the variable remuneration. This would create a connection between the undertaking's integration of sustainability risks and the remuneration of employees.

The provision in article 5 does not require the undertakings to disclose information on whether the remuneration policy incentivises employees to contribute to the achievement of the undertaking's sustainability targets. The undertakings' considerations on their impact on sustainability are only relevant for the information required under article 5 to the extent they are clearly linked to the sustainability-related financial risks.

3. Observations and expectations of the DFSA

This section presents the DFSA's main observations from the review and expectations for good practice in the area. The observations relate to:

1) how the undertakings describe sustainability risks in their remuneration policies;
2) how the undertakings have published the information; and
3) whether the undertakings comply with the information stated in the remuneration policies.

[3] Thematic review of article 3 of the disclosure regulation

3.1. Information on sustainability risks in the undertakings' remuneration policies

As mentioned above, the main purpose of article 5 is to enhance transparency on how the undertakings' remuneration structure contributes to ensuring an adequate handling of relevant sustainability risks.

The DFSA's review shows that all but one undertaking in the review address sustainability in their remuneration policy. However, in some cases, the information primarily describes incentives aimed at enhancing the undertaking's positive *impact* on society while it relates less to incentives aimed at ensuring that sustainability *risks* are considered in the undertaking's investment decision-making processes and/or advice.

The DFSA expects the undertakings to distinguish between, on the one hand, objectives for sustainability impact on society and, on the other hand, sustainability risks for the undertaking's investments and, ultimately, the undertaking's investors. As mentioned above, sustainability risks are to be understood as in article 2 (22) of the SFDR. This means that remuneration policies that take into consideration integration of sustainability risks will seek to ensure that the undertaking's remuneration structure is consistent with the undertaking's work on risk management in relation to ESG factors, which may potentially have a negative impact on the value of an investment. Information on the undertakings' considerations on sustainability impact on society is thus only relevant for the information required under article 5 to the extent that it is clearly linked to sustainability-related financial risks.

The DFSA also notes that the undertakings covered by the SFDR must maintain policies for integration of sustainability risks in their investment decision-making processes and investment or insurance advice, cf. article 3 of the SFDR.

The review furthermore shows that the information provided by the undertakings, which state that the remuneration policy is consistent with the undertaking's integration of sustainability risks, lacks details on *how* the remuneration structure promotes adequate risk management in respect of sustainability risks. In most cases, the information in the remuneration policy is limited to a statement of intent, e.g. that the remuneration structure must 'promote sound risk management, also considering sustainability risks', or a general statement that the undertaking considers sustainability risks in its remuneration. This is considered to be inadequate, as the undertakings thus do not describe *how* granting of variable remuneration takes into consideration the integration of sustainability risks.

The DFSA expects that undertakings, which state that there is a connection between remuneration and integration of sustainability risks, clearly describe in the remuneration policy how the remuneration structure contributes to ensuring non-excessive risk taking in relation to sustainability risks. It is especially important that the remuneration policy describes in which way integration of sustainability risks may constitute a criteria for granting and determining variable remuneration, including in the form of bonus schemes and one-off payment. As it is a policy, it does not necessarily have to be an elaborative description. Similarly, the DFSA's expectation for the level of detail follows the proportionality principle that applies under the Danish rules on remuneration.

3.2. Publication of information on the undertakings' websites

The DFSA finds that there are different approaches to publication of the information required under article 5.

All the undertakings under review had published their remuneration policy on their website. In a few cases, it was not possible to locate the remuneration policy or the specific information on sustainability risks by clicking around on the undertaking's website, but only by using the search field to find a link to the remuneration policy.

The DFSA expects that the undertakings publish the information required in article 5 on a subsection to the undertakings' main website.

Other undertakings had made the required information available on the website separately from the remuneration policy. These undertakings had created a subpage for sustainability-related information, which included a description of how the undertaking's remuneration policy is consistent with sustainability risks and a link to the remuneration policy.

In the view of the DFSA, it may be appropriate for the undertakings to gather sustainability-related information on a single subpage with links to additional information and relevant documents. This will make it possible for investors or customers to read the information directly on the website in a condensed form. However, besides any condensed information on the website, the undertakings must always incorporate information on how the remuneration policy is consistent with the integration of sustainability risks in their remuneration policy, cf. article 5(2) of the SFDR. In case the information is published several places, it is important that there is consistency between the information provided in the remuneration policy and the information provided directly on the website.

3.3. Compliance with the policies

As a part of the review, the DFSA has assessed whether, in practice, the undertakings comply with the information on sustainability risks that they have stated in their remuneration policy.

For this part of the review, all six undertakings forwarded their internal guidelines for the annual review of the remuneration policy as well as the most recently conducted annual review of the remuneration policy.[4] Sustainability risks were not included as an element to consider in the undertakings' guidelines for the review of the remuneration policy.

Some undertakings also forwarded examples of contracts on variable remuneration schemes. According to the undertakings, the contracts showed that sustainability risks had been taken into consideration in accordance with the information they had provided in the remuneration policy.

The DFSA found that only some of the contracts in fact contained elements relating to sustainability risks within the meaning of the SFDR. An example of this could be that the contract entailed that the variable pay would be negatively affected if the employee had not complied with the undertaking's policy for integration of sustainability risks in the investment decision-making process.

The remaining examples of contracts contained KPI's, which seemed to incentivise the promotion of the undertaking's impact on ESG issues in society rather than ensure the reduction of the undertaking's exposure to financial risks. An example of this could be that the employee had to achieve X pct. 'green investments' by 2025 or was granted variable pay based on 'non-financial goals' (such as CSR-related goals or goals for communication on sustainability).

If an undertaking considers that a positive sustainability *impact* contributes to reducing the undertaking's exposure to sustainability risks in its investments, it should appear clearly from the information, and a description must be made on how this connection is ensured.

In general, the DFSA expects that undertakings ensures compliance with the information on sustainability risks published in their remuneration policy, that compliance can be proved and that it is supported by reassuring internal control framework.

[4] Danish financial undertakings are required to establish guidelines and carry out an annual review of their remuneration policy, according to Danish rules on remuneration.