CONSULTATION PAPER: ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MIFID II

I. General remarks

The Spanish Banking Association welcomes the consultation “Integrating sustainability risks and factors in MiFID II”.

This Association shares the European Commission Action Plan on Financing Sustainable Growth objectives: improve the contribution of finance to sustainable and inclusive growth and strengthen financial stability by incorporating Environmental, Social and Governance (ESG) factors into investment decision-making. In this regard, ensuring that investor savings are efficiently allocated to sustainable projects plays a fundamental role.

The EC Action Plan on Financing Sustainable Growth, published on March 8th, included the amendment of delegated acts under Directive 2014/65/EU on markets in financial instruments (MiFID II) and Directive (EU) 2016/97 on insurance distribution (IDD) to ensure that sustainability preferences are considered in the suitability assessment.

This proposal, Integrating sustainability risks and factors in MiFID II, goes far beyond the above mentioned as it proposes to include sustainability risks and factors in areas like organisational requirements, risk management, conflicts of interests and product governance.

In the field we are dealing with, environmental, social and governance preferences, developments are still at initial stage.

As stated in the CP there are still several ongoing legislative workstreams in this area (e.g. the Commission’s proposals on the establishment of a framework to facilitate sustainable investments; on disclosures relating to sustainable investments and sustainability risks; on benchmarks; and on the establishment of a unified EU classification system of sustainable economic activities (‘taxonomy’)).

This circumstance implies a significant risk since the impact of the proposed modification based on an undetermined taxonomy and definitions cannot be evaluated. Therefore the effects of the future legislation are unclear. It should be recommendable that the ESG principles shall be included in MIFID legislation after the taxonomy is completely defined and fully operative. It is crucial to know the scope and to analyse the consequences of the new information requirement.

The proposal of taking into account the preparatory work of the EC or “current market practices” (without any further definition or delimitation)\(^1\) creates a high level of legal uncertainty and anticipates expensive regulatory developments only applicable in a short term.

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\(^1\) Parr. 8, page 14 Consultation Paper
In this regard, it is also important not to create new legal concepts. Any legal concept already defined by MIFID legislation should be referred to such legislation, and it should be avoided new definitions for the same concepts. Inconsistencies and overlappings have to be prevented because they can mislead investors, markets and can imply a non-negligible burden for the entities.

Therefore, the main message at this point of time is that ESG principles should only be included in MiFID and other legislation when the taxonomy is completely defined. At this stage it cannot be clearly defined nor properly assessed due to the legislative proposals in process.

Secondly, it is very important that regulation assigns clearly responsibilities to each player. The responsibility of the entities as investment advisor should be clarified. The liability should rest with the issuer of the financial products.

The definition of the ESG concept depends on the criteria and standards outside the scope of the capital markets and on the knowledge and experience of those who operate in them, and particularly of the entities that provide portfolio management and investment advice services.

Therefore, embedding the ESG criteria and factors into capital markets should be done in a progressive and sequential way, so agents can interiorise them and guiding their expectations to take better financial decisions.

Therefore, the EC’s legislative proposal on the establishment of a framework to facilitate sustainable investment should also provide a clear definition for the ESG concept, and this legislative proposal -on the integration of ESG criteria in the suitability assessment (MiFID II)- should be fully aligned with the aforementioned classification.

The obligations for these entities should include products with ESG “label” in their offer and in the portfolios of the interested clients, but in any case, should not include the verification of the ESG criteria in the underlying companies or products. These firms are not in a position to make such verifications and liability should rest in the issuer of the relevant instrument.

III. Specific questions

ORGANISATIONAL REQUIREMENTS

Q1: Do you agree with the suggested approach and the changes to the Article 21 of the MiFID II Delegated Regulation on ‘general organizational requirements’? Please state the reasons for your answer.

If, despite the need to wait until ESG regulation is clearer, develop rules in this area is decided, the AEB agrees with ESMA that a principles-based approach is the right one. Any other detailed prescription, besides being premature would create regulatory arbitrage and regulatory errors.

Some kind of guidelines would be appreciated in order to assure that it is considered correctly by firms. Also, it would be appreciated to clarify what is considered “relevant”
Q2: Do you agree with the suggested approach and the changes to the Article 23 of the MiFID II delegated regulation on 'risk management'? Please state the reasons for your answer.

Changes in article 23 of the MiFID II delegated regulation should be carefully done as it directly implies the development of policies and procedures. The obligation of taking into account environmental social and governance factors should be only mandatory when these factors are being defined.

As commented previously, some kind of guidelines would be appreciated, in order to state specific risks that could be established for each taxonomy objective.

Furthermore, we would insist on the need that a common risk methodology should be stated, in order to have the same way of measuring ESG risk amongst the industry. In fact, this point was previously suggested, and it was included in the amendments in 2018/0179 (COD) of 18th of September 2018.

Q3: Do you agree with the suggested approach and the new recital on 'conflicts of interest'? Please state the reasons for your answer. What would be specific examples of conflicts of interests that might arise in relation to sustainability considerations?

The content of recitals generally refers to the rational beyond regulation or the need of regulation. The fact of including here risks that will not be developed in the following rules does not seem a very accurate practice.

Conflicts of interests are regulated in general terms in MiFID without mention any specific case. These general terms would include ESG conflicts where necessary and there is no need to emphasize these ones as they were more important than others.

It is difficult to think about examples of conflicts of interests arising in the context of sustainability. The examples of misselling named in the CP are not specific of ESG considerations and are already considered by the rule. They should not happen in any case, and if they do, there is a rule already in place that its already been neglected.

Q4: Do you think that on the topic of ‘organizational requirements’ other amendments should be made to the MiFID II Delegated Regulation in order to incorporate sustainability risks and factors? If yes, which ones? Please state the reasons for your answer.

The Association considers that there are no other amendments to be made at least for the time being.

PRODUCT GOVERNANCE

Q5: Which existing market standards or “labels” are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or “labels”? Please describe.

Due to the nature of the Spanish Banking Association this question is not applicable.

However, the Association wants to stress the importance of the “labels” mentioned here.
The definition of the ESG concept depends on the criteria and standards outside the scope of the capital markets and on the knowledge and experience of those who operate in them, and particularly of the entities that provide portfolio management and investment advice services.

The obligations for these entities should be to include products with ESG “label” in their offer and in the portfolios of the interested clients, but in any case, will include the verification of the ESG criteria in the underlying companies or products or responsibility when the “label” is not correctly defined or granted.

In this regard, the ECO-label initiative from European Commission must be mentioned. This is one of the cases where the final development is needed before regulating other areas like MiFID which development should be subsequent to the taxonomy and “sustainable” definition.

Q6: Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Directive Articles on ‘product governance’? If not, please explain.

The implementation of the MiFID II has meant an important effort in terms of costs and time for the subject entities. We consider that introducing new requirements in relation to the identification of the target market requires new developments in systems and an additional classification of the target market for the instruments that invest in this type of asset. Being aware of the importance of environmental, social and governance issues, and of the responsible investment in this type of assets, we consider the main objective of the regulation on product governance is that of investor protection, and this can be carried out by gathering general information about their investment preferences in one or other assets without entering into such a detailed case that will undoubtedly involve new non-negligible costs for the entities and, therefore, a possible increase in the price in the provision of the service.

In addition, the definition of ESG is not clear and it transfers the responsibility to the distributor on which assets meet these characteristics. Please bear in mind that the Guidelines on MiFID II product governance requirements establish that “Firms that distribute products that have not been manufactured by entities subject to the MiFID II product governance requirements are expected to perform the necessary due diligence so as to provide an appropriate level of service and security to their clients compared to a situation where the product had been designed in accordance with the MiFID II product governance requirements”. In this respect, as stated previously, it is essential that the regulation clarifies that the responsibility to determine if a financial instrument meets the ESG criteria should rest in the issuer.

An explicit reference to ESG preferences emerges a question of how to fulfill this in the “European Market Template” (EMT) document which includes the target market, and also an explicit mention would be a concern.

Does the explicit mention means that a new additional column will have to be included in the EMT (where the Target Market is described) in order to reflect if the product takes into account these factors?

The proposed amendment to the delegated directive is not considered as necessary. As stated in the CP, the ESG preferences should be included in the category “characteristics and objectives”. These are not detailed in any article of the Delegated Directive.

Other “characteristics and objectives” are not detailed in the delegated directive (preservation of capital, leveraged, recommended holding period...) so the flexibility needed is maintained.
This should be the case for ESG preferences even more if we take into account the nature of this parameter.

As ESMA states, including a reference to clients’ ESG preferences in the “objectives and needs” category does not necessarily imply that the investment products is not compatible with clients who do not have those specific objectives or needs, so there is no reason for specifying it in the delegated directive as if it were more important or remarkable than other criteria.

Q7: Do you agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements and the addition of an additional case study? If not, please explain what changes should be made and why.

This is clearly the way the regulatory amendment should be made. As other factors (period, tax, currency protection...) included in the category “clients’ objectives and needs” the ESG preferences should be detailed in ESMA Guidelines.

However, it is very important that the guidelines specify the special nature of this preference. As ESMA states, including a reference to clients’ ESG preferences in the "objectives and needs” category does not necessarily imply that the investment product is not compatible with clients who do not have those specific objectives or needs.

ESG considerations should not result in a factor for the definition of the “negative market” in any case.

Q8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.

Yes. More guidance is needed referring the “matching process”. It is not enough explaining that ESG considerations should not be relevant as a factor in the definition of the “negative market”. In the other way round, clients with ESG preferences should not be excluded from offering products with no ESG label. If this was the case, the offer for those clients, at least in the early developments of this new regulation should be very much limited.

Q9: Please specify any approach you see to identify environmental, social and governance criteria separately from each other or as a single indicator. Please explain how the criteria would interact with each other and how the target market assessment and matching would be performed in such cases.

Matching this indicator with clients’ needs would be really complicated if regulation requires that environmental, social and governance criteria should be considered separately. Although in a detailed taxonomy the three factors would be probably defined separately, there should be only one indicator which will cover the client preferences.

Q10: What current market standards or “labels” are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or “labels”? Please describe.

ESG regulation is in a very early stage, methodologies to evaluate products from the point of view of ESG are in development, and there are still no globally shared valuation models. Special difficulty poses to incorporate the governance factor in relation to products. At the same time
some “labels” are appearing in the market. It is very important that regulation clearly assigns responsibilities of each player in this new field.

**SUITABILITY**

**Q11: Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines? If not, do you have any suggestions for developing a more detailed approach with regard to (a) the collection of information from clients and (b) the assessment of ESG preferences with the assessment of suitability?**

ESG considerations may form part of investor’s objectives and, therefore, in such cases it may make sense to consider them when providing investment advice or portfolio management.

We consider as the most important point how the question is proposed to the clients. In this sense, we defend flexibility in this subject, in order to avoid any potential negative target market or any restrictive answers. For example, it could be focused as if the client would accept products which would not include only ESG factors. In this sense we insist in the previous idea mentioned before: we expect that no negative target market is considered if a product does not have ESG characteristics while the client has certain ESG preferences.

However, ESMA suitability guidelines have been very recently updated.

In the new version ESMA has already included, pending changes to the legal framework, a good practice for firms asking about their clients’ ESG preferences and taking them into account when assessing the range of financial instruments and insurance products to be recommended, i.e. in the product selection process and suitability assessment.

The good practice will contribute to raising firms’ and supervisors’ attention and awareness of this issue. ESMA will monitor the legislative proposals under the EC action plan and will consider making focused amendments to the guidelines to reflect changes to the MiFID II delegated acts on the topic of sustainability. So, as result of this, we do not support amending the par 28 in ESMA Guidelines at this point of time.

Including ESG preferences should be maintained as best practice and not mandatory. As said in point 10, “the willingness of a client to invest in environmentally sustainable, social or good governance products should not be used against the interests of that client”. This information could be only of interest for the companies with ESG products, and furthermore, it could be collected only for the purposes of the objective of ESG interpreted by ESMA (only as a specific need or objective).

In addition, it should be borne in mind that the scope of the investment advice provided by a firm may vary and, therefore, ESG considerations may not be relevant for the particular investment advice service for each client. In this respect, MiFID II recognizes that investment firms may establish different approaches to the scope of investment advice and that the advice may be based on a broad or a more restricted analysis of different types of financial instruments. For instance, a firm may provide an investment advice which is addressed specifically to hedging the interest rate risk arising from the financial positions of clients. In this case, ESG considerations would not be relevant for the scope of the advice and, therefore, information on the client’s ESG preferences would not be part of the suitability assessment.

There must be a clear reference taxonomy for entities and clients officially approved, or at least recognized, prior to the incorporation of ESG considerations in the suitability procedures with any more detail than the one already recognized. It seems premature proposing any other
ESMA guidelines modification.

Q12: Please specify any approach you see to assess environmental, social and governance criteria separately from each other or as single preferences. Please explain how the criteria would interact with each other and how the suitability assessment would be performed in such cases.

As explained in Q9, performing suitability assessment with ESG preferences would be really complicated if regulation requires that environmental, social and governance criteria are considered separately.

Q13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

When the risks factors are mentioned, it should be taken into account that a standard methodology to measure this kind of risks is needed (as it has been done in PRIIPS).

Q14: What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk-management arrangements, market researches and analyses, organizational costs, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organization and the nature, scale and complexity of the activities of your institution, where relevant

Important IT are expected as relevant technical changes should be made, design and modification of the Suitability Test, review of the calculation algorithms of the tests, redefinition of the way of evaluating the products incorporating ESG factors, reclassifying products, modifying the counselling process (product selection, content of proposals, ...), specific training for employees, etc. Consultancy services would be a one off cost at the beginning.

In any case, it is hard to evaluate the impact for this proposal until the final definition and entry into force of the necessary ESG taxonomy. What is sure is that enough time should be granted in order to complete these changes properly.