PORTUGUESE BANKING ASSOCIATION RESPONSE TO ESMA CONSULTATION PAPER ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MIFID II (REF.ª ESMA 35-43-1210)

Introductory Remarks

The Portuguese Banking Association (APB) welcomes the present consultation on the integration of sustainability risks and factors in MIFID II.

We consider, nevertheless, that the scope of ESMA’s proposal goes beyond the mandate provided by the European Commission, which is restricted to investment firms that provide portfolio management and/or investment advice. That scope is perfectly clear in the last paragraph of the Commission’s request for advice (mandate), that was suppressed in ESMA’s consultation paper.

Lastly, we would like to emphasize the need for clear definitions, to ensure a consistent consideration of sustainability risks and factors in the different regulatory measures currently under discussion regarding sustainable finance and sustainable investment.

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

We consider that the proposal to include ESG considerations in the general organisational requirements where they “are relevant for the provision of investment services to clients” seems a proportionate approach.

The inclusion of these factors may also prove helpful to support a desirable assessment of sustainability risks in organizational requirements.
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.

No.

We support the integration of sustainability risks within the MiFID II requirements through a high-level principle-based approach, similar to that already followed for all other relevant risks (e.g. credit risk, market risk, liquidity risk), as proposed by ESMA.

Nonetheless, we consider that the integration of ESG risks should be done following the same line of reasoning of the general organisational requirements – when those risks are relevant.

Therefore, Article 23 of the MiFID II Delegated Regulation should be amended as follows:

Investment firms shall take the following actions relating to risk management:

(a) establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall also take into account environmental, social and governance factors, when they are relevant.

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?

No.

Although we believe that it is important - for ethical, reputational and transparency reasons - for any investment firm to consider potential conflicts of interest that may arise from the distribution of environmentally sustainable, social or good governance
investments, we do not recommend the adoption of the text proposed in the new recital 59.

ESMA proposes to add the new recital 59 (bis) of the MiFID II Delegated Regulation:

“When identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments.

Firms should have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process and portfolio management does not lead to mis-selling practices.”

The justification presented is that “ESMA considers (...) useful (...) to clarify that when identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that stem from the distribution of (i) investments in companies that adopt environmentally sustainable practices, are socially responsible, and/or have good corporate governance; or (ii) financial instruments that provide exposure to sustainable investments, social investments, and/or good governance investments.”

ESMA intends to address mis-selling practices or misrepresentations that damage the interests of clients to whom ESG factors are considered important.

We consider that this approach is biased, in the sense that it assumes that conflicts of interest, regarding ESG factors, may arise only due to the distribution of environmentally sustainable investments, social investments or good governance investments. However, some clients may not deem ESG considerations important and conflicts of interest may also arise due to that fact - for example through the sale of shares of a coal company to investors, who do not have an exclusion policy on coal, although this investment may not be in their best interest.

Therefore, we would suggest a more general approach on conflicts of interest, to be reflected in the new recital 59 (bis) of the MiFID II Delegated Regulation:
“When identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that may stem from ESG preferences”.

Q4: Do you think that on the topic of ‘organisational 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.

No.

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.

Financial institutions use a wide range of different labels and nomenclatures, which provide different results, due to the lack of a common market standard.

The lack of a common market standard that adequately identifies all ESG factors implies that banks and other organisations use a variety of terms and nomenclatures with different understandings, scale, and contexts. It is important for banks to effectively and efficiently enforce financial literacy. In our view, discrepancies in market standards turns comparisons either difficult or impossible for customers and the market in general, compromising the opportunity to “talk the same language” when ESG factors are applied or used.

Therefore, the adoption of a taxonomy as a common glossary on environmental, social and governance issues – that can be used by credit institutions, issuers, distributors, certification bodies, etc – is an important step forward.
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.

Yes, we do agree with the suggested amendments to the MiFID II Delegated Directive Articles on product governance, to include ESG preferences of clients, where relevant. We also agree with the approach to include ESG characteristics for the two types of target market described: (i) target markets in which certain ESG characteristics are specified (“ESG positive products”) and (ii) target markets without any reference to ESG characteristics (“non ESG products”).

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.

We agree that guideline 18(e) is the most adequate place to stiffen the inclusion of ESG preferences, since the current version of the ESMA Guidelines on MiFID II product governance requirements already mentions “green investment” and “ethical investment” as examples of “specific investment objectives”. Nevertheless, we believe that the characteristics of the target market criterion should be clearly outlined, as a clear definition of sustainability is still lacking.

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

Further guidance on these issues is welcome, given the importance, but also the somewhat lack of interconnectedness between ESG factors and financial products. We consider that the three topics listed in paragraph 15 are a good starting point, but we urge that such guidance must be further developed and kept in close connection
with the developments and level of detail of the EU taxonomy proposals, that will follow a stage-by-stage approach.

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.

We consider preferable to adopt an approach that identifies environmental, social and governance criteria separately from each other, since the ongoing regulatory proposals in the EU have a progressive approach, reflecting the priority given to climate-related issues over social and governance issues.

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.

Please see answer to Q5.

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?

No.

It should be made clear that when clients express that ESG considerations should not be taken into account in their investment preferences and/or services, there is no need to ask detailed questions in relation to ESG factors.
Furthermore, we understand the aim for granularity in the information collected on clients’ ESG preferences but it is important to mention that such information could be difficult to collect, namely in a first stage, and without a solid and widespread framework put in place, such as the expected EU taxonomy.

We believe that the cost implications of modifying the suitability evaluation and IT developments should be taken into account.

We welcome the adoption of the proportionality principle in the Guidelines regarding the integration of sustainability risks and sustainability factors, especially keeping in mind the recent MiFID II implementation costs.

It is important to ensure that the sustainability assessment of products and services is not, in the future, contradicted by the EU taxonomy. This would be burdensome for financial institutions, concerning the adaptation to new requirements, and also create possible liability risks in relation to past recommended products, that would no longer be suitable to clients’ expectations.

Furthermore, we also highlight that it could be useless, and costly, for firms to consider other current market standards in the meanwhile (unless they are currently using them), regarding the work done so far in the UE taxonomy, and the expected outcome, even if gradual, in the short term.

Therefore, we would suggest the following text:

“When collecting information about their clients’ ESG preferences, firms should firstly ask if ESG considerations should be taken into account. Only in the affirmative case, firms should ask questions in relation to environmental, social and governance factors. The information collected on clients’ ESG preferences should, be granular enough to allow the firm to assess the suitability of the investment and should be consistent with the EU’s classification system of ESG investment products, once developed. While this classification system is under development, investment firms should clearly specify what they consider to be ESG preferences or considerations, while taking into account current market standards.”
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 previously mentioned, we consider preferable to identify environmental, social and governance criteria separately from each other.

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

Yes, we do agree with the suggested amendments to paragraph 70 of the suitability guidelines, to include ESG considerations, where relevant.

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, organisational 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 organisation and the nature, scale and complexity of the activities of your institution, where relevant.

As an example, the obligation to develop ESG criteria with insufficient guidance can imply substantial operational, legal and reputational risks.

The possibility of significative costs related with the introduction of new regulatory obligations that will soon be superseded by the EU taxonomy should be kept in mind.