CONSULTATION RESPONSE

ESMA CONSULTATION PAPER ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MiFID II
SUMMARY OF RESPONSE

Though MiFID II is primarily targeted at investment firms, the proposals affect both distributors and producers, in particular in the fields of product governance and suitability.

DEFINITION OF SUSTAINABILITY RISK

We believe defining which ‘sustainability risks’ are to be addressed is crucial going forward. We therefore ask ESMA to propose a more detailed definition of the meaning of ‘sustainability risks’ in further regulatory documents (also taking into account the definitions proposed by the European Parliament, the European Council and the European Commission, if applicable).

Additionally, the distinction between ESG ‘considerations’, ‘preferences’ and sustainability ‘risks’ should be clarified and EU guidelines should specify how to operationalise those concepts.

It needs to be clarified that ‘sustainability risks’ and the integration of ESG considerations do not coincide with the EU Taxonomy. The taxonomy provides a thorough list of activities that are considered environmentally sustainable. Green or environmentally sustainable funds in the future ought to relate to the taxonomy, which should be a main factor when selecting green funds. The taxonomy does not however establish standards for ESG practices, and therefore should not be used as a key variable when selecting ESG funds, or when analysing the credentials of ESG integration in investment processes.

Our understanding is that sustainability risks should include (1) direct risks to the performance of an investment emanating from ESG considerations, but also (2) those risks, particularly systemic risks such as climate change, which would affect or entail a risk to the ability of the system to ensure sustained economic growth, and which therefore could pose a risk to the investment and undermine the ability of financial actors to ensure long-term sustainable returns. This is particularly the case for climate change or resource scarcity.

Some risks might be perceived as systemic risks rather than direct risks to the performance of an investment when looked at in a short term perspective, while in fact in the long term they might have a direct impact on the performance of the investment itself.

The consideration of ESG factors in investment research and analysis as well as in investment decision-making processes are geared to protect the value of the investment, and sometimes, their inclusion also ensures lower volatility.

From a risk management perspective, ‘sustainability risks’ should be considered the same as any other investment risks. An integrated approach (for sustainability and other risks) will ensure that any interrelations between non-sustainability and sustainability risks are properly captured. In addition, some factors might comprise both aspects and should therefore be identified, assessed, managed and monitored in an effective, integrated system.

We also believe that compliance with the ratified minimum governance and social standards as stipulated in the OECD Multinational Enterprises Principles should also be considered. ESG can also
be a framework for identifying and evaluating opportunities, and for improving fundamental research, and therefore, their consideration enhances investment decision-making.

The EU’s non-financial reporting directive, for example, includes the impact of businesses to the environment and society. This is particularly relevant for some disclosures to policy makers, for example, but also when conducting thorough ESG assessment of companies’ long-term performance, or reporting a fund’s environmental or social footprint.

IN FAVOUR OF LESS HIGH LEVEL, MORE DETAILED APPROACH

Our concern is that ESMA’s principle-based approach on the integration of sustainability risks and factors is too high level and too ambiguous. It will not guarantee a level playing field as national regulators will not have the same interpretation or application.

BNP Paribas Asset Management would rather have a more detailed definition of ‘sustainability risks’ that should be taken into account as well as a prescriptive approach on the integration in the suitability test and product governance.

The way investment firms ask clients for their potential ESG preferences and the recommendation then given is crucial and should be harmonised.

ABOUT ORGANISATIONAL REQUIREMENTS: LIMIT OBLIGATION TO PORTFOLIO MANAGEMENT AND ADVICE

We believe ESMA’s proposal regarding ‘general organisational requirements’ is too vague, since it does not clearly state what part of an investment firm it applies to. The proposed changes in Article 21(1) “Where ESG consideration are relevant for the provisions of investment services, firms should take them into account […]” lead to uncertainty as to the scope. To reach the 3 main goals of the EC’s Action Plan on Sustainable Finance, we believe that the only investment services that must consider ESG factors are the portfolio management service and the advisory activity. Other investment services (e.g. RTO, execution) do not help to reach the Sustainable Finance Action Plan’s goals.

We would therefore recommend to leave Article 21(1) unchanged and to introduce appropriate changes in the relevant articles.

ABOUT PRODUCT GOVERNANCE

We agree that ESG considerations should be integrated into the decision process, which consists in identifying the potential target market and specifying the type(s) of client whose needs, characteristics, objectives and preferences the financial instrument is compatible with.

Additionally, we believe that it would be necessary to specify the scope of ESG considerations with regards to product governance, since it is not relevant for all types of assets. We would therefore recommend not only to add ‘where relevant’ to the proposed amendments, but to also clarify this

1 Directive 2014/95/EU lays down the rules on disclosure of non-financial and diversity information by large companies. This directive amends the accounting directive 2013/34/EU. Companies are required to include non-financial statements in their annual reports from 2018 onwards.
point in ESMA’s final technical advice. As an example, **currency swaps or Forex should not be required to include ESG in their target market.** The assessment of the target market and the compatibility of a financial product with or without ESG characteristics must be done (i) in relation to all five categories provided in MiFID 2 for the determination of the target market, and then (ii) in relation to the consideration of the ESG factors that intervene as a sub-criterion of the category ‘Objectives and needs’.

It **should also be clarified** that different ESG strategies can be applied to a financial product. Their specificities and implications should be disclosed to the end client.

**ABOUT SUITABILITY**

From a suitability perspective, **we agree** that ESG considerations should be included in the process of determining whether a financial instrument meets the identified objectives, characteristics, objectives and preferences of a client.

**We believe** a more detailed approach of the integration of ESG considerations to suitability would be crucial.

If the client wishes to integrate one or several of these factors into his investment strategy, the recommendation **should be** for a product which integrates specific E, S or G objectives in **its strategy**. When pan-European labels that reflect ESG strategies are in place, the recommendation could be for a labelled product. Until then, the integration of sustainability risks and factors in the investment process of the producer or manager of the product should not be enough to match an E, S or G investor preference. **The E, S or G factors must also be in the objectives of the product.**
DETAILED SUMMARY OF CONSULTATION QUESTIONS & BNP PARIBAS ASSET MANAGEMENT’S RESPONSE

2 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 organisational requirements’? Please state the reasons for your answer.

- We believe ESMA’s proposal regarding ‘general organisational requirements’ is too vague, since it does not clearly state what part of an investment firm it applies to. The proposed changes in Article 21(1) “Where ESG consideration are relevant for the provisions of investment services, firms should take them into account [...]” lead to uncertainty as to the scope. To reach the 3 main goals of the EC’s Action Plan on Sustainable Finance, we believe that the only investment services that must consider ESG factors are the portfolio management service and the advisory activity. Other investment services (e.g. RTO, execution) do not contribute to the Sustainable Finance Action Plan’s goals.
- We would therefore recommend to leave Article 21(1) unchanged and to introduce appropriate changes in the relevant articles.
- We recommend that the term “ESG risks and opportunities” should be used instead of “sustainability risks and factors”.

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.

- The suggested approach to ‘risk management’ remains vague and should be more specific, particularly since there is yet no clear vision at the European level of what ESG risk management entails. A clarification of how to integrate ESG considerations at the operational level would be welcome. We suggest referring to the UN-backed Principles of Responsible Investment (PRI) and their recommendations. The PRI is today the international framework and is supported by more than 2,230 signatories across the world.
- We believe defining ‘sustainability risks’ is crucial going forward and ask ESMA to try and propose a more detailed definition of the meaning of ‘sustainability risks’ in further regulatory documents (also taking into account the definitions proposed by the European Parliament, the European Council and the European Commission, if applicable). Please see our aforementioned definition of sustainability or ESG risks.
- Additionally, the distinction between ESG ‘considerations’, ‘preferences’ and sustainability ‘risks’ should be further clarified and EU guidelines should specify how to operationalise those concepts.

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 additional comment.
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.

In line with the PRI’s response, we recommend additional language in Commission Delegated Regulation 2017/565/EU (MiFID II delegated regulation) to provide explicit clarification of the relationship between sustainability and investor duties as articulated in Article 24(1) of Directive 2014/65/EU (MiFID II directive). We recommend the following language:

- Investment firms shall take into account Environmental, Social and Governance (ESG) risks and opportunities, consistent with the investment timeframe of the clients, in investment processes and stewardship activities.
- Investment firms shall proactively seek to understand the ESG preferences of their client and shall incorporate those preferences into their investment decision-making and their stewardship activities where possible.
3 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.

- BNPP strongly supports the creation of a range of ESG or Sustainable Finance European labels, through the Ecolabel but also through other labels that reflect and address the different ESG integration available and viable strategies, including a normative approach, stewardship activities, positive and negative screening and ESG integration in fundamental research. Once a social taxonomy is developed, we also encourage the development of a Social Label for Social Impact Investments (that is, in social enterprises).
- Our concern is that the multiplicity of national labels creates barriers to entry by setting different standards across different countries. They add confusion to the market by setting different requirements for the same type of products and objectives. Further, the combined cost of national labelling and promotion of the labels adds transaction costs to precisely the funds and capital flows that the EC Action Plan on Sustainable Finance aims to foster.

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.

- We agree that ESG considerations should be integrated into the decision process, which consists in identifying the potential target market and specifying the type(s) of client whose needs, characteristics, objectives and preferences the financial instrument is compatible with.
- Additionally, we believe that it would be necessary to specify the scope of ESG considerations with regards to product governance, since it is not relevant for all types of assets. We would therefore recommend not only to add ‘where relevant’ to the proposed amendments, but to also clarify this point in ESMA’s final technical advice. As an example, currency swaps or Forex should not be required to include ESG in their target market. The assessment of the target market and the compatibility of a financial product with or without ESG characteristics must be done (i) in relation to all five categories provided in MiFID 2 for the determination of the target market, and then (ii) in relation to the consideration of the ESG factors that intervene as a sub-criterion of the category ‘Objectives and needs’.
- It should also be clarified that different ESG strategies can be applied to a financial product. Their specificities and implications should be disclosed to the end client.

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.

Yes, we agree with the case study. No additional comments.

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

- If the client puts the accent on one or several of these factors in his/her investment strategy, the recommendation should be for a product which is geared to address E, S or G objectives in its strategy. That is, if the client’s preferences reflect a predilection for environmental
objectives, a green or environmentally sustainable product should be recommended. However, while the accent might be put on one of the three pillars of sustainability (ESG), most funds do apply minimum ESG standards across the portfolio, and that should be encouraged.

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 believe environmental, social and governance criteria should be identified both separately from each other AND as a single indicator, in the latter case with certain minimum standards.

Indeed, it is important to distinguish between the different main objectives and strategies that might be applied:

- **Ensuring sound risk and opportunity management of environmental, social and governance issues.** This implies that the companies or fund issuers have a good management of their social and environmental externalities or impacts, and that they have good governance standards. There are funds that emphasize the good practices of one of the 3 pillars of ESG or sustainability e.g. a best-in-class approach where stocks are selected for exhibiting best corporate governance performance (or ratings). ESG integration in this case means good ESG practices. Several approaches are used across the market, including ESG integration in fundamental research, positive or negative screening or normative-based approach: all underlying stocks are compliant with international best practices or norms e.g. UN Guiding Principles of Business and Human rights, OECD Multinational Enterprises Guidelines, etc.

- **Investing in environmental solutions,** that is, in those technologies, services or products (activities) that contribute substantially to one or more environmental objectives. These funds will have to relate to the taxonomy in the future.

- **Investing in social enterprises,** that is, in businesses or activities that contribute substantially and primarily to a social goal (or to overcome a social objective). They might be subjected to a future social taxonomy, if developed.

- **And any combination of the above.** In fact, most environmental or social funds will also ensure good ESG practices across the board. It is important therefore to explain to the end client the difference in strategy and in terms of social and environmental impacts. There are those funds that minimise environmental and/or social negative impacts, and ensure best practices; and those that go further and contribute positively to the environment or the society by investing in solutions to social or environmental challenges.

- Should also be considered the extra value that an **active stewardship strategy** (voting, engagement with companies) can add to an equity fund.

- Finally, to examine ESG integration approaches, three dimensions ought to be considered:
  - Issue (what ESG research is being considered and analysed),
  - Stock (how the stock is being analysed and eligibility of the stock)
  - Portfolio construction (overall objectives or specific requirements)
4 SUITABILITY

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.

- We favour the development and use of a range of ESG, social and environmental labels at European level that reflect the different objectives and approaches as explained in Q8.
- We are currently though taking into account for specific funds the following labels:
  - LuxFlag environmental label for our environmental funds, the French SRI label for our Best-in-Class SRI funds (invests in the companies of each sector that better perform in terms of ESG according to our proprietary ESG rating) and Finansol for social funds.
- We believe that the development of European standards will facilitate capital movement and raising capital in the investments the EC Action Plan aims to favour, while lowering the transaction costs inherent to having to adapt portfolios to different standards and to applying to multiple labels.
- We believe all investments should respect international minimum social, environmental and governance standards irrespective of their objectives. European countries have ratified the OECD MNEs Principles and Guidelines, therefore they should be mandatory. Nevertheless, further or stricter requirements and higher standards, while commendable for all labels, would be more appropriate for a general ESG label and not a specific Green label such as the Ecolabel.

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?

- We believe the suggested amendments are acceptable if ‘EU’s classification system of ESG investment products’ can be understood in its broadest sense, and if it is made clear that this classification system does not necessarily coincide with the EU Taxonomy. That is only true for environmentally sustainable or green products. The taxonomy provides a thorough list of activities that are considered environmentally sustainable. Green or environmentally sustainable funds in the future ought to relate to the taxonomy, which should be a main factor when selecting green funds. The taxonomy does not however establish standards for ESG practices, and therefore should not be used as a key variable when selecting ESG funds, or when analysing the credentials of ESG integration in investment. However, we encourage European authorities to define ESG investment products through an ESG general label(s), and what it means to integrate ESG, based on the work done by the UN-backed Principles of Responsible Investment.

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.

See question 9.
Q13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

We agree that it is important to clarify that ESG considerations should be taken into account by firms, when classifying products, in order to assess whether these products are suitable for clients who have expressed ESG preferences. To this end, firms should also take into account the analysis conducted for the purposes of product governance requirements, similarly to what is done in relation to other product features.

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.

We believe it is critical to properly train financial advisors on what integrating ESG factors implies, how it can be conducted and the different approaches available; as well as on the particularities of Sustainability thematic funds (environmental or social). While this implies a significant cost, we recognise the long-term value of educating financial advisors in relation to sustainability and sustainable financial products. However, the European Authorities, and national ones, should contemplate the development of technical and know-how transfer between countries, institutions and alongside the financial value chain, and not least promote and educate citizens on sustainable finance.