ABI’s remarks to the ESMA Consultation Paper on integrating sustainability risks and factors in MIFID II

February 2019
Foreword

The Italian Banking Association (ABI) welcomes the opportunity to contribute to this consultation launched by ESMA on integrating sustainability risks and factors in MiFID II.

We are fully aware of the importance of the broad Commission's initiative on sustainable development aimed at putting Environmental, Social and Governance (ESG) considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system.

We are also aware:

- that a critical prerequisite for an orderly development is a clear and harmonised classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity. But such taxonomy will be finalised in the upcoming years and, at least initially, it will not cover social and governance issues;
- of the high search costs that are currently attached to sourcing reliable and useful sustainability-related information;
- sustainability risks should not prevail over all the other relevant risks (i.e., credit risks, market risks, liquidity risk) which affect the provision of portfolio management and investment advice.

Therefore, we have to underline that it is crucial to find the right balance in integrating the ESG consideration in MiFID II in order to avoid an overly prescriptive regulation on such forward looking topic – whose legal and regulatory framework is still evolving – as well as disproportion as far as it regards the importance given within the MiFID II relevant provisions to ESG factors related to financial factors (market risk, credit risk, liquidity risk).

As to avoid uncertainty or negative impacts, ESG principles shall be included in MiFID after the other legislative proposals included in the action plan are finalised, all definitions adopted and fully operational.

Moreover, it is very important that regulation assigns clearly responsibilities to each player. The responsibility of the entities as investment firms should be clarified: 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 investment firms are not in a position to make such verifications and liability should rest in the issuer of the relevant product.
Here below are illustrated our considerations concerning the draft amendments proposed by the consultation paper.

1. 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.

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.

Answer: We appreciate the intention, expressly stated by ESMA, of adopting a high-level principle-based approach for the integration of sustainability risks within the MiFID II requirements, similar to that one already followed for all other relevant risks (e.g. credit risk, market risk, liquidity risk).

In our view, such a high-level principle-based approach would imply that no integration of reference to ESG factors is required within provisions related to “general organisational requirements” (Art. 21 of the MiFID II Delegated Regulation) and “risk management” (Art. 23 of the MiFID II Delegated Regulation), as these provisions do not contain any reference to the other relevant risks/financial factors which must be considered within the provision on investment services. Consistently, no additional recital should be introduced related to “conflict of interest” (Recital 59-bis of the MiFID II Delegated Regulation).

Mentioning only ESG factors would, therefore, lead to an unbalanced regulation and raise the risk of producing unintended implications.

We feel that, consistently with the whole MiFID II framework, the most appropriate approach would be to identify clearly the specific organisational requirements (i.e. product governance) which need to be integrated with ESG factors. According to the current general organisational requirements and risk management provisions, investment firms would consequently be obliged, according to the proposed amendments to the Guidelines on product governance and suitability, to adequate their processes, systems and controls in their entirety in order to comply with the new specific requirements related to ESG factors.

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?
**Answer:** In line with our remarks above, we question whether the first paragraph in Recital 59 (bis) adds any additional value as investment firms under applicable rules should already identify all relevant conflicts of interests, which would include those that stem from distribution of environmentally, social or good governance investments.

We have not identified a clear reason to add a new recital on ‘conflicts of interest’. If needed, more guidance on sustainability considerations as triggers for conflicts of interest can be provided in the form of Q&A.

The (proposed) potential conflicts relate to the performance of the investments, rather than conflicts of interests between parties (investment firm and/or clients) as the current articles in the Delegated Regulation relate to.

We, therefore, believe that no additional recital should be introduced related to “conflict of interest” (Recital 59-bis of the MiFID II Delegated Regulation).

**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.

**Answer:** No, we believe that no amendment at all should be made on the topic of organisational requirements to the MiFID II Delegated Regulation.

### 2. 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.

**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.

**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.

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

**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.

**Answer:** We believe that product governance – and not suitability – is the area of MiFID II that suits itself to be integrated with ESG factors as it is
linked to the decision-making process with which investment firms decide the range of products to offer to their customers.

We therefore agree with the proposed amendments to MiFID II provisions (Articles 9 and 10 of the MiFID II Delegated Directive and ESMA Guidelines on MiFID II product governance requirements).

We also agree with:

- the proposal to limit the integration to a simple reference to ESG preferences as at this stage – in the absence of a clear and finalized taxonomy - we believe that it is untimely to require more;
- the consideration that ESG preferences are relevant only in a positive way for the target market of investment products. Therefore, with regard to the ESG preferences in the “objectives and needs” category, a negative target market does not need to be specified.

However, we have to underline that MiFID II/Delegated Directive relates to investment services and in principle not to the offering/issuance of investment products. Only manufacturers that qualify as investment firms, meaning investment firms that produce an investment product and provides an investment service regarding to that same investment product, are in scope.

Most investment products (shares, bonds and funds) are not manufactured by investment firms. The result is that most “producers” of investment products are not legally required to provide target market information. This puts the burden on distributors to collect this information.

Most target market criteria can be derived from the type, nature and conditions of the investment products and/or regulatory mandatory disclosures regarding to these investment products (prospectus). The current target market criteria do not include or indicate the (environmental) activities and governance of the underlying company/issuer.

The target market criteria/ESG factors should be included in the regulatory framework applicable to the offeror/issuer of investment products (UCITS/AIFMD/Prospectus Regulation/etc.). ESMA is aware of this: “Going forward ESMA considers that the EC should consider the possibility to align the relevant UCITS and AIFMD articles with the product governance obligations for manufacturers.” (ESMA Final Report 19 December 2014 | ESMA /2014/1569, paragraph 9, page 52). In our view, ESMA forgot to mention the Prospectus Regulation. As long as the “producers” of investment products are not legally required to provide information regarding to the ESG factors when relevant, it is not legitimate to put the obligation to provide the same information on the distributors.
3. 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.

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?

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.

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

Answer: We believe it is essential to provide as much flexibility as possible to the methodological approaches through which investment firms can integrate ESG preferences within their suitability model.

Consistently with ESMA Guidelines on MiFID II suitability requirements, investments firms have so far implemented sound policies and procedures:

- in order to properly classify investment products which are coordinated with those procedures linked to product governance and, in particular, with the definition of the range of products to be offered to clients taking into account the target market, the combined type of investment services and the criteria to determine the product equivalence, also taking into account the charging structure. In this area, there is room for introducing proper criteria aimed at considering also ESG factors according to the service model adopted by each investment firm;
- aimed at taking into account the client’s portfolio as a whole (and the asset allocation within that portfolio) as well as a proper degree of risk diversification (the client’s portfolio exposure to the different financial risks). In this regard, ESG investments should not be treated differently from the other types of investments, as they too are exposed to financial risks, have a reward profile and an holding period. That being so and taking into account that the market is far from having reached maturity in this field, it is really crucial to leave investment firms free to find the better approach to coordinate the strict suitability assessment with ESG consideration.

In view of this, we agree with that “firms are expected to (i) take into account ESG preferences in the context of assessing client’s investment objectives
and (ii) to consider ESG factors in the context of product classification. With these amendments, ESMA suggests at this stage the adoption of a high-level approach that leaves sufficient flexibility for implementation by firms and for developing some supervisory practice by NCAs in a field where, at present, there is very limited practical experience”. Consequently, we agree with the suggested amendments to Paragraph n. 28 and 70 of the ESMA Guidelines.

While the amendments leave room for flexibility, we do not agree with the timing. As we stated above, we believe a taxonomy must be in place before changes to the MiFID II Delegated Directives or Guidelines could be made.

Until that moment in time the wording should remain limited to a recommendation and not be written down as an obligation.

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.

Answer: Implementing the ESG requirements as proposed in this consultation paper will require an impactful change in the product offering and review process, as well as the client intake and review of existing clients. Products on offer will have to be assessed on ESG criteria and the onboarding of new clients and the review of existing clients has to be adapted. Therefore, the level of necessary (financial) resources will be substantial. Also, the IT costs and training costs should not be under estimated.