Response of DKB to the European Securities and Market Authorites' Consultation on Sustainable Finance Factors in MiFiD II

Deutsche Kreditbank AG welcomes ESMA's consultation and its intention to seek the integration of sustainability risks and factors in MiFID II.

As the second leading direct bank in Germany with 4 million retail clients and a strong business presence in credit provision for sustainable and social projects, DKB is committed to constructive dialogue with both national and European legislators in the interest of all market participants and a stable European finance sector.

In general, we welcome the EU Commission's ambition to foster sustainable investment as lined out in the EU Action Plan on Green Finance. In addition, we support ESMA's high level principle-based approach to integrate ESG risks and factors into MiFID II. Furthermore, we agree with ESMA's consideration regarding the early stage of the market for sustainable finance and its on-going establishment. As a result, regulatory approaches should focus on encouraging innovation, enable market transparency and ensure a level playing field among all market participants.

Summary

- Sustainable investment is of major importance to institutional and private investors alike. Similarly, financial markets are a perfect instrument to utilise capital and can act as a strong promoter for a greener and more sustainable European economy. As a manufacturer and distributor of Green and Social bonds as well as ESG fonds, we encourage the EU's initiative to improve market transparency and to enable clients to make better informed investment decisions based on ESG considerations.

- Increasing market transparency and the availability of information of financial products with positive ESG factors to customers and market participants should be at the heart of the EU's legislative programme. As a result, the on-going development of a market for sustainable finance should be supported by establishing common market standards for ESG factors across Europe to ensure a level playing field for the benefit of all clients. In this context, we recommend to implement a measured and valid link to the SDGs (Sustainable Development Goals of the United Nations). Once achieved, clients can identify ESG positive investment products more easily and the growing demand of ESG positive investment products can be satisfied at an early stage.

- Therefore, we strongly uphold ESMA's principle based approach to integrate ESG factors into MiFID II and agree that a common taxonomy including standardised ESG ratings will best enable greater market transparency and improve the ability of clients to invest in ESG positive finance products.

- The introduction of ESG factors to product governance procedures and the suitability assessment is appreciated but should be constructed along the same logics as the current MiFID II suitability assessment.

This is best done by summarising ESG factors under one additional category in the target market and the suitability assessment. Furthermore, EU standardised ratings for ESG products would be appropriate as well as necessary to increase the client's ability to identify sustainable investment products and to make a fully informed investment decision.

Question 6: 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.

As a manufacturer and distributor of green and social bonds as well as ESG fonds, we appreciate the integration of positive ESG factors in the target market of investment products. This is an appropriate measure to increase market transparency for customers and ensure that firms can adequately identify and distribute suitable positive ESG investment products to their clients.

Nonetheless, the plan to add a new case study in which specific ESG preferences are set out in detail does not represent a measure proportionate to the aim of promoting sustainable finance. Currently, the consultation envisions that manufacturer and distributors should specify the ESG preferences "with a meaningful level of granularity" (paragraph 9). Similarly, a new case study is set out which identifies ESG factors along the six environmental objectives identified by the EU Commission (paragraph 8).

However, including such detailed description in the target market assessment is increasing the complexity substantially and is difficult to perform and to implement, especially in the mass retail market.

Firstly, MiFID II had introduced target market categories that are usable for the definition of potential and actual target markets of investment products in the mass retail market. Nonetheless, the newly proposed case study does not fit into this existing scheme properly but requires an even more complex sub-division of ESG financial products into the six proposed environmental objectives that was not foreseen in the technical implementation of MiFID II.

Secondly, the proposed level of granularity can further reduce the availability of financial products for private clients as a target market assessment of complex ESG investment products with several investment objectives will be more difficult to be performed by investment firms. As a result, the implementation of a granular differentiation of ESG preferences may lead to a limitation of the product range available for private clients and thus counteract the goal to offer sustainable finance products to a wide variety of clients and portfolio sizes.

Therefore, we underline the importance of implementing only one single ESG factor in the target market assessment without any subdivisions into separate environmental, social and governance criteria.

We propose that a more detailed differentiation may better be achieved via the introduction of EU wide labels and ratings for investment products. These EU standardised labels are also the appropriate measure to differentiate between environmental, social and good governance factors.

Question 8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.

Generally, we welcome ESMA's approach to integrate an ESG factor in the identification and assessment of the potential and actual target market (see question 6). Nonetheless, considering the on-going market development, the need for further guidance by ESMA for the target market assessment of investment firms does not seem evident.

By introducing just one single ESG factor for the target market assessment and by providing a common taxonomy, the EU Commission and ESMA would better prepare the framework for the evolving market and will help to establish a level playing field across the EU. Thus, European clients will be put into a position of choice and can further enhance the development of different ESG factor in the market by creating demand for more ESG specific investment products.

Question 5 and question 10: 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"?

As an issuer of Green and Social Bonds, we welcome the development of common market standards regarding sustainable finance. The consultation paper currently considers the FNG Siegel as a relevant eco-rating scheme for Germany *(see page 25 of the consultation paper, footer).* Despite its general usage, the FNG Siegel so far only applies to investment funds and does not apply to other forms of investments such as shares or bonds. Consequently, we would like to make ESMA aware of the alternative 'Oekom ISS Rating' as an alternative rating approach to identify and classify sustainable investment products.

Generally, we support the EU Commission's ambition for a common taxonomy on sustainable finance in order to promote comparable sustainability ratings for different investment products. This is of particular importance in order to promote a level playing field and ensure that sustainability labels are comparable across investment products and also across member states of the EU.

Currently, a small range of labels exists but market standards still differ widely. For instance, an investment in nuclear energy production may be seen as 'sustainable' and 'green' in one Member State but might not be considered as such in another Member State. As a result, difficulties may arise when investment products with a national positive ESG rating by a rating agency of one Member State shall be sold in another Member State where the product would otherwise be considered unsuitable for the client.

Consequently, we suggest the EU Commission and ESMA put a focus on the establishment of a common framework in order to avoid an inconsistent patchwork of varying sustainability labels and to promote a shared European market standard.

Question 11: 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?

The consultation paper currently proposes a two step approach to assess the product suitability for a client. In a first step, relevant provisions such as knowledge, experience, the financial situation and financial investment objectives should be identified. In a second step, ESG preferences should be taken into consideration *(see paragraph 11, page 23)*.

This suggested two-step approach by ESMA is based on the assumption that for every level of knowledge, experience and financial investment objectives, products with an ESG rating are available on the investment market. Thus, this two-step approach can only be appropriate and efficient once a broad market of sustainable finance products for retail clients has evolved in the future. Apart from that, assigning a two-step suitability assessment is in a strong opposition to the aforementioned aims of ESMA to focus on a high-level principle approach and weakens ESMA's aim to enable a broad range of clients to allocate part of their investment into products with positive ESG factors.

In light of the ongoing formation and creation of a market for sustainable finance, the proposed two-step approach currently risks reducing the range of suitable products significantly. As a result, clients may be subject to only a very limited choice of investment products, because very few investment products might meet their suitability criteria in the first step and their ESG preferences in the second. Consequently, clients and their portfolios can potentially be less diversified and contain only very limited ESG investment products. This unintended consequence counteracts the aim of the EU Commission to support efficient capital allocation and deepen financial markets. Additionally, it also hinders the ability of private clients with smaller portfolios to invest in ESG positive products while having a comprehensive risk diversification at the same time.

As a result, we suggest that Level 1 and Level 2 regulation should firstly focus on the development of common market standards by developing a coherent taxonomy for the ESG factors. Secondly, the competent EU authorities can foster market transparency by promoting sustainability ratings via ESG labels.

Once standardised sustainability ratings and greater market transparency have developed, it is appropriate to introduce ESG suitability criteria in the suitability guidelines.

Furthermore, to allow for the inclusion of ESG factors in the suitability assessment, we recommend a more comprehensive approach which assesses a client's ESG preferences along the general suitability criteria. Our proposal envisions an approach by which the suitability assessment will be performed in one step as designed under MiFID II. If the client has expressed ESG preferences beforehand, they will be considered as well in the suitability assessment to find the most suitable product out of the investment firm's product range. If no suitable ESG product can be found, the investment firm may – as suggested in paragraph 14, bullet 2 of the Consultation Paper - offer another suitable product that is not categorised as ESG.

This approach also allows for a more holistic investment advice and reduces the likelihood of a one-sided and misbalanced investment portfolio of the client.

Additionally, we would like to point out that the suggested methodological approaches in paragraph 12 (*'simplified approach' and 'portfolio approach'*) are very ambitious by ESMA to be implemented by investment firms and do not take into account the currently still evolving small market of sustainable finance products.

At first, the simplified approach foresees the assignment of percentages of a client's portfolio towards ESG investments. The consultation paper does not define whether those percentages are calculated based on the portfolio's volume or per number of financial products held in the portfolio. This approach becomes particularly problematic when clients are able to access their portfolio in an "execution only" approach as well. Thus, the client would be in the position to manipulate or shift the determined balance of ESG and non-ESG products in the portfolio. It would be useful if ESMA could specify this approach in more detail.

Secondly, the 'portfolio approach' also increases the complexity of any investment advice considerably. The approach aims to match an ESG profile of a client's portfolio with the client's ESG preferences. However, this is very difficult to implement for three reasons. Firstly, there is limited availability of financial products that are defined along the three ESG factors (environmental, social and good governance). Secondly, investments in balance funds or mixed products will be difficult to be adequately categorised along the ESG factors. Thirdly, it would require investment products not only to have a positive ESG rating but a very granular assessment between the three ESG factors (environmental, social, good governance). Based on previous considerations to Question 6, we do not think this measure is proportionate and in line with the aim to provide a broad range of clients with ESG positive investment products.

Question 12: Please specify any approach you see to assess environmental, social and governance criteria separately from each other or as a single preference. Please explain how the criteria would interact with each other and how the suitability assessment would be performed in such cases.

Based on the previous considerations, the suitability assessment of an investment product is not the best approach to incorporate varying degrees of ESG criteria by separate different factors.

Across EU member states different understandings of positive environmental, social and good governance criteria exists. In order to avoid regulatory arbitrage and to ensure the availability of ESG investment products to all market participants, we again propose that ESMA and the EU Commission foster the development of common rating standards. Thus, market transparency and the development of ESG labels will increase and facilitate the identification of ESG positive products by investment firms.

Including a granular differentiation of ESG factors in the definition of the potential and actual target market and the suitability assessment significantly risks reducing the available range of finance products. At the same time, it can also act as a market barrier for private clients as an ESG product with an uncommon combination of the three ESG factors may suddenly be deemed unsuitable for the client, because his combination of ESG factors cannot be matched entirely with the ESG factor combination of the investment product. Additionally, the integration of separate ESG factors increases the complexity of the suitability assessment and will lead to strong issues regarding the implementation in the current IT systems that support both the suitability assessment and the target market categories of an investment product.

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