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Comments

**ESMA Consultation Paper On integrating sustainability risks**

**and factors in MiFID II**

Association of German Banks

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**General comments**

We welcome the publication of the European Commission’s “Action Plan: Financing Sustainable Growth” and support the development of sustainable finance within the European Union. We agree with the Commission’s initiative to take ESG considerations into account when providing investment advice or portfolio management services, but believe it will be necessary to have a common, reliable and sustainable taxonomy in place before any enhancements of the existing financial market regulations come into effect in order to avoid fragmentation of the market and best serve clients’ interests.

Especially when it comes to the definition of enhanced and additional measures for manufacturers and distributors, we share ESMA’s opinion, as mentioned in the Consultation Paper, that the fragmented legal framework and the absence of a clear view of the outcome at Level 1 on sustainable finance legislation are challenging. The lack of legal definitions, e.g. of sustainability risks or factors, makes integrating sustainability risks and factors problematic at this point in time, from both a “better regulation” and implementation perspective.

For this reason, but not limited thereto, we would like to recommend considering the timing of the proposed changes to MiFID II. MiFID II represents a significant reform of the market, introducing broad changes for both clients and investment firms that only took effect in January 2018. Any changes to MiFID II should be aligned with the scheduled review process in order to ensure that both investment firms and clients are prepared.

We fully agree that sustainability is one of the key objectives of the European project and of the goals of the European Commission expressed in the Action Plan and understand the approach to mirror this in the existing legislative framework. Instead of amending certain articles or recitals, and to avoid any misunderstanding or inconsistencies, we would like to propose adding a general statement in a new recital, saying that ESG factors and risks shall also be considered – where relevant – in the requirements and measures of the respective directives or regulations.

In view of numerous open questions on fundamental aspects, e.g. the taxonomy, the requirements should on no account be too detailed at this stage.

**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.**

Article 21 of Delegated Regulation (EU) 2017/55 contains “high-level principles”, i.e. it sets general organisational requirements that cover all investment services and ancillary services provided by an investment firm. Any further specification of these requirements has rightly been dispensed with to date. This ensures that, when complying with Article 21 of Delegated Regulation (EU) 2017/565, investment firms take into account all relevant aspects, including future or hitherto unknown ones.

Despite their principles-based approach, the existing supervisory rules on organisational requirements are specific enough to take due account of ESG considerations.

The inclusion of ESG considerations would therefore only be justified if particularities were to apply in regard to these. This does not appear to be the case, however, nor is it explained and substantiated by ESMA. Instead, ESMA, too, stresses that ESG considerations are relevant for the suitability of a recommendation (investment advice) or investment decision (portfolio management). Thus, in regard to Article 21 of Delegated Regulation (EU) 2017/565, the same is likely to apply to ESG considerations as to the suitability criteria that already have to be met today. Consequently, there is no need for the proposed amendment of Article 21 of Delegated Regulation (EU) 2017/565.

As an explicit reference to ESG factors would thus merely be a clarification, we advise against including this amendment. It could, in effect, be misunderstood to mean that ESG factors might be assigned more importance than other factors. Such uncertainty should be avoided.

**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.**

Article 23 of Delegated Regulation (EU) 2017/55 contains “high-level principles”, i.e. it sets general requirements for an investment firm’s risk management. Any further specification of these requirements has rightly been dispensed with to date. This ensures that, when complying with Article 23 of Delegated Regulation (EU) 2017/565, investment firms take into account all relevant aspects, including future or hitherto unknown ones.

Despite their principles-based approach, the existing supervisory requirements for risk management are specific enough to take due account of ESG considerations.

The inclusion of ESG considerations would therefore only be justified if particularities were to apply in regard to these. This does not appear to be the case, however, nor is it explained and substantiated by ESMA. Consequently, there is no need for the proposed amendment of Article 23 of Delegated Regulation (EU) 2017/565.

An explicit reference to ESG factors would thus merely be a clarification. This clarification could be misunderstood to mean that ESG factors might be assigned more importance than other factors. Such uncertainty should be avoided.

Irrespective of this, we consider any integration in the tasks of the compliance function – whether capital markets compliance or banking compliance – to be inappropriate. While such compliance functions also keep an eye on risks, they focus mainly on risks resulting from non-compliance with legal rules and regulations and less on monitoring all types of risk. We are therefore against any explicit general requirement for involvement of the compliance function.

**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 existing requirements for dealing with conflicts of interest are “open”, i.e. they do not exclude any potential conflicts of interest. All potential conflicts of interest specified by ESMA in paragraphs 12ff of the Consultation Paper are already taken into account today within the scope of management of conflicts of interest relating to the investment services of investment advice and portfolio management.

There are no particularities in regard to ESG considerations that would justify highlighting these.

An explicit reference to conflicts of interests resulting from the distribution of ESG investments would therefore be merely a clarification. Nevertheless, we advise against including clarifying recital 59, since it could be misunderstood to mean that conflicts of interest resulting from the distribution of ESG investments might be assigned more importance than other conflicts of interest.

Misleading client information, including advertising material on the sustainability of, for example, a financial instrument (catchword: “green washing”), would already breach Article 24 (3) of MiFID II, so that there is no need for regulatory action in this respect either.

**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 – no other amendments should be made.

**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.**

There are no market standards for ESG factors. There are many different approaches and methodologies relating to ESG factors, although none of these has yet prevailed. They are not comparable with each other either. This is also why the Technical Expert Group on Sustainable Finance (TEG) appointed by the Commission has not yet managed to come up with a uniform taxonomy.

In our view, it would make sense to have a (minimum) standard that product manufacturers or certification bodies can use. Also helpful would be if certain labels or certifications already available in the marketplace identifying a product’s ESG criteria as sustainable may be used.

Since there is, as yet, no standardised EU-wide approach, an internationally recognised label would be welcome. However, the ESG preferences as per the proposed taxonomy that ESMA intends to take as a basis are much too granular in our view. Investors will not normally distinguish between climate change mitigation and climate change adaptation or between waste prevention and protection of healthy ecosystems. Such a detailed approach is, we feel, too complex for clients and too challenging for investors. A single “sustainability” label should therefore be sufficient.

The challenge when it comes to the use of labels will be how to explain the integration of sustainability to clients. While labels may create transparency and comparability, explaining exclusion criteria and their application remains difficult. Explaining the differences between recognised approaches such as “best in class” and “impact investing” in a comprehensible way will also be challenging. As long as there is no taxonomy, reference to the body awarding the “sustainability” seal and its criteria should be sufficient.

If issuers and distributors understand the “sustainability” of a product differently, this product cannot be duly matched with the client’s preferences. The consequence could be the client being recommended a product that does not reflect his or her actual preferences.

A further negative consequence would be distributors deciding to include in their range of products only products of issuers to which they maintain close ties so that there is a common understanding of their classification. This would be at odds with an “open architecture” benefitting the client. This risk was also recognised by ESMA in the final report on the product governance guidelines. May we refer, by way of example, to the following extract from guideline 16:

 *“….In the decision, whether to use such additional categories or not, manufacturers may take into account the characteristics of the information-channels with distributors. For example, in order to facilitate the exchange of information with distributors and to foster open architecture, manufacturers may limit the use of additional categories to cases where these are essential to define a meaningful target market for the product.”*

This need for standardisation acknowledged by ESMA also applies in relation to the introduction of ESG factors.

Distributors must be able to feed the ESG criteria identified by issuers into their existing automated processes, since only through automated processing can ESG criteria be taken into account in mass retail business. The condition for automated processing is a high level of standardisation, as otherwise matching clients and products of different issuers is not possible. To allow this, a common understanding of “sustainability” by issuers and distributors is essential.

Such standardisation would also be in the interest of investors, as it would improve transparency and comparability. From a client perspective, it would be confusing if manufacturers use widely differing designations for the same characteristics or clients cannot tell whether issuers understand the same thing under the same designation.

ESMA should, moreover, propose that manufacturers who declare their products sustainable also draw attention to this point in the legally required key information documents (KIDs). For example, Article 8 (3) (c) no. 2 of the PRIIPS Regulation says that environmental and social objectives targeted by the product should be set out in a section titled “What type of product is this?” In this context, may we point out that the Level II act provided for in Article 8 (4) of the PRIIPs Regulation which could give manufacturers further guidance on the classification of products as environmental or social has not yet been presented (the ESA draft was not, as far as we can tell, followed up by the Commission). Until the Taxonomy Regulation is finalised, the Level II act provided for in the PRIIPs Regulation must be used to set a legal framework for manufacturers on the tricky question of product classification, compliance with which will lead to a certain degree of standardisation. Distributors rely on appropriate information from manufacturers, which is why the relevant legal requirements for manufacturers and distributors linking the interaction of all players in the supply chain should at any rate come into force simultaneously.

With regard to funds, ESMA should also propose that investment funds companies /managers which declare their products sustainable must also draw attention to this point in the UCITS/AIF KIDs. Article 7 of Regulation (EU) 583/2010 (KID Regulation), which contains requirements for specifying the “objectives and investment policy” of investment funds, could thus be amended to include a reference to this effect.

**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 Consultation Paper appears to assume that it is up to the manufacturer and the distributor to identify the target market and the ESG criteria (see CP, page 13, paragraph 6). ESG criteria can, in our view, only be identified by the respective issuer, as only the issuer has the required information and data. Distributors, on the other hand, do not usually have access to an adequate data basis to be able to reliably identify ESG criteria of a product they did not themselves issue.

Distributors must be able to rely on identification of the ESG criteria by the issuer.

We share ESMA’s view that ESG criteria should not automatically lead to exclusion of investors. It is right that investors without ESG preferences can be recommended “ESG-positive products” as well for other reasons (e.g. superior performance). Conversely, it is also possible for investors with ESG preferences to be recommended “non-ESG products”. It is positive that this aspect is also highlighted by ESMA in the Consultation Paper (see CP, pages 23/24, paragraph 14).

We support ESMA’s assessment that ESG considerations are not relevant as a factor in the definition of a “negative target market” (see CP, page 15, paragraph 15).

ESMA’s product governance guidelines stipulate five categories for identifying the target market. Due to systematic differences, the ESG criteria should stand alongside these five categories. At many institutions, implementation of the target market requirements entails the five target market categories excluding investors whose characteristics are not in line with a certain product feature. As intended by ESMA, precisely this does not apply with the ESG criteria. The target market categories specified in ESMA’s product governance guidelines must be observed in some cases both in investment advice and in non-advisory business. ESG preferences, on the other hand, only have to be taken into account in investment advice and asset management. Conversely, ESG criteria need not be taken into account in non-advisory business (with and without a suitability assessment) (see CP, page 23, paragraph 11). This does not, however, rule out investment firms opting to link ESG criteria to the five target market categories in their operations.

We believe it is right for investment firms to have broad discretion when it comes to incorporating ESG criteria within their own specific suitability processes (see CP, page 22, paragraph 9).

To give the investment firms affected enough time for implementation, the new requirements should be applicable no earlier than 24 months after their publication in the Official EU Journal.

**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.**

Given that the key Taxonomy Regulation is still outstanding and there is no legal definition of “sustainability”, it should suffice if a manufacturer classifies a product as “sustainable”. Further specification of, for example, sub-criteria, would only increase the existing legal uncertainty. This may lead to distributors including in their range of products only products of issuers to which they maintain close ties so that there is a common understanding of their classification. This would be at odds with an “open architecture” benefitting the client.

A positive feature is the clarification that a mismatch between product and client preferences (client wants a sustainable product and recommendation is geared to a non-sustainable product, or the client has no ESG preferences – adviser recommends a sustainable product) does not lead to any deviation from the target market.

The case study should be altered:

The title of the case study would first have to be changed: “Target market assessment of a non-complex UCITS” instead of “Simple investment fund”. “Simple” is not a specific legal term under MiFID.

The case study criteria would have to be reworded as follows:

• Investor knowledge and experience: clients with basic capital markets knowledge or experience

• Client objectives and needs: the first three bullets should be changed to “depending on the duration of the product, the UCITS may be suitable for clients who seek capital growth and have a medium-term investment horizon”.

The proposed criteria are, however, at odds with case study 5 and are by no means compatible with customary market standards. A standardised exchange of data would therefore not be possible.

The risk indicator of 2 appears unrealistic.

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

No – no extra guidance is needed. We agree with the Consultation Paper that ESG considerations should not be relevant as a factor in the definition of the “negative target market”.

**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.**

Given the fragmented legal framework and the absence of market standards, indication of an aggregated criterion for whether a product is sustainable or not should suffice. Further differentiation would only be possible if there were clear legal requirements in this respect or a common market understanding. Both are missing, however, so that further specification of sustainability should take place within the scope of the further legislative procedure.

**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.**

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?**

A more detailed approach than the proposed amendment of paragraph 28 of the suitability guidelines is not possible in our view.

It should be made clear that the examples given in paragraph 12 of the Consultation Paper are non-binding examples in the event that a portfolio approach is chosen and that a portfolio approach is (still) not mandatory with regard to suitability.

In our view, ESG considerations are only of relevance in investment advice, so that, instead of the “investment and advisory process”, paragraph 14 of the Consultation Paper should refer solely to the “advisory process”.

**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.**

The use of a single, aggregated indicator for ESG preferences is appropriate and adequate. Environmental, social and governance criteria basically rank equally alongside each other.

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

As we understand it, ESG considerations are explicitly mentioned merely by way of clarification. Such clarification could, however, wrongly create the impression that ESG considerations would particularly have to be taken into account. To avoid this misunderstanding, we suggest dropping the clarification.

**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.**

It is difficult to estimate the costs under the current conditions.

Regulators should keep in mind the high costs of introducing new regulatory obligations that will soon be superseded by the EU taxonomy. Those costs pertain to, for example, modifying the sustainability tests as well as the IT processes, including underlying algorithms. Consequently, it is problematic that entities will have to develop processes and criteria to comply with obligations that may change very soon.

 Some examples of the costs that will be incurred by distributors:

One-off costs

From a distributor perspective, the investment process has to be amended end-to-end:

* Manufacturer submits data to data provider
* Data provider submits data to distributor
* obtaining ESG information from manufacturers
* product governance processes
* questionnaire
* suitability assessment
* tools that support advisors in recommending a suitable financial instrument
* suitability statement
* [reporting: no legal requirement, but clients may want to understand whether their objectives have been achieved]
* These systems also need to be maintained on an ongoing basis.

In addition,

* all investment advisors have to be educated
* all clients (investors) have to be educated as well, since most of them have no clear idea of ESG
* ESG information has to be requested from all clients that want advisory or discretionary portfolio management services

Running costs

* acquisition of ESG data
* The advisory process will require more time especially in case the client gets into a “trade-off situation”

Generally speaking, the more detailed the ESG considerations that have to be incorporated are, the more complex implementation projects will be, with higher complexity requiring more financial and human resources.

We estimate that German banks alone face one-off implementation costs in the three-digit million euro range.