

HSBC Response: ESMA Consultation on Integrating Sustainability Risks and Factors in MiFID II

General remarks

HSBC supports ESMA's high level principles-based approach, and we welcome the recognition that detailed prescriptions – when large parts of the EU sustainable finance policy landscape are still not yet in place – would be premature and could result in error and additional risks. A high level principles-based approach is appropriate in light of the range of existing approaches to sustainable investment and multiple frameworks defining environmental, social and governance (ESG) factors.

Climate change and the financing of action to prevent it or to adapt to its consequences need to be seen in the context of the broader financial ecosystem and should not be viewed either as a niche set of assets or through a narrowly defined investment lens. The commercial priority is to make sustainable finance into a more globally relevant set of propositions, which promote innovation and dynamism.

1) Current market standards

- ESMA refers to “current market standards” in a way that implies there is a common and uniform market in third party (vendor) ESG ratings. Our own research and analysis highlights differences in the quality of the data, their methodology and, in some instances, inconsistencies between the ratings that companies are given.
- For this reason we urge ESMA to recognise that the landscape of ratings and advisors is continually evolving, and thereby the mechanisms by which sustainability factors are incorporated into the investment process require judgement and flexibility. An investment firm's approach to integrating ESG/ sustainability risks may be delivered using a range of external data and research, with proprietary analysis and research to inform end decision making.
- In addition the ESMA paper discusses the role of “labels”. We believe labels can play a role, but only as one tool for investors. In our experience, and evidenced by the labels provided in the consultation paper, they tend to be national in focus. In addition they serve as a basis for investors to promote one type of investment philosophy. They should not serve as a benchmark for investors as this may lead to a reduction in choice of products for customers.
- We believe that as market practice evolves, ESMA should assess this and provide guidance on what good practice looks like, taking into considerations of potential implications for firms to implement additional changes into their systems, controls and processes for compliance.

2) Definitions

- We agree with ESMA's focus on high level principles and agree that detailed definitions are not required at this point in time.
- We would welcome ESMA to clarify and recognise that, in line with our analysis above, the industry has yet to reach a common approach on sustainability risks and how best to integrate these into the investment process – in large part because which ESG factors are material to companies and the investment process are dependent on e.g. sector, country, product and

are constantly evolving e.g. in response to regulations. An overly prescriptive approach at this stage is likely to restrict innovation in this growing area.

- The consultation expects firms to implement these proposals, in the absence of an agreed EU Taxonomy, and then update again in light of the final agreed taxonomy. We question the rationale of firms having to implement these factors into their systems, controls and processes twice – when there could be major differences between a firm’s approach to ESG and the EU’s final Taxonomy which “at least initially, will not cover social and governance issues”. A hasty implementation may create more confusion, especially for clients, particularly as there is a lack of a consistent market standard, and before the Taxonomy is to be finalised by end 2022. For this reason, we call upon ESMA to consider in its technical advice to the Commission the idea of separating its work on ESG under MiFID II from the Taxonomy. We argue this for the very simple reason that the work of the TEG is not taking a high level principles-based approach to its work, seeking instead to provide sector definitions of “sustainable economic activities” and we are therefore concerned that ESMA’s work on ESG may be incompatible with the current direction of the TEG’s work on taxonomy.

3) Suitability

- We are supportive of a measure that would require a firm to collect information on clients’ ESG preferences. However, we do not consider that a client’s ESG preferences should prevent non-ESG products from being treated as suitable if they otherwise meet the clients’ financial objectives and needs, unless the client expressly adds this as a constraint to investment choice. For example, a client may like to make money whilst promoting gender diversity in the businesses he/she wants to invest in, but if a suitable product is not available that also meets the clients’ financial goals/investment horizon, then that preference should not prevent the client from investing.

4) Implementation and compliance

- We believe the current approach of adopting a high level principles-based approach is the right one.
- We believe progress can be made, in the absence of definitions, via;
 - The provision of guidance on the appropriate level of disclosure a firm should provide to explain its approach to integrating sustainability risks. This could include internal governance and control functions / internal policy framework to be disclosed. We note that signatories to the Principles for Responsible Investment are required to provide a detailed annual self-assessment on the extent to which they meet the principles which includes integration of ESG issues into the investment process.
 - A minimum 12 month review clause after the entry into force to assess the progress and implementation of the recommendations, with consideration of the right balance between providing refined guidance on definitions and additional costs and resources required by firms to implement changes twice.

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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.

HSBC supports the suggested approach which is in line with ESMA's support for a high level principles based approach.

We have two specific comments on the proposal:

1. ESMA's amendment states that ESG considerations should be considered where they "are relevant" to clients. As we describe later in our response, there is very little uniformity as to how ESG is interpreted and applied in the market, thereby placing considerable burden on firms to define their own test for relevance. We would ask ESMA to clarify or provide guidance on what appropriate disclosure is required for firms to interpret "where relevant".
2. We believe it should be up to firms to decide how they ensure their staff have the appropriate skills and expertise. It will be important for ESMA to clarify what "necessary people, skills and knowledge" entails.

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.

HSBC is supportive of ESMA's view that "singling out sustainability risks (amongst the various risks that are relevant for firms) is unnecessary to achieve the Commission's objectives and would be disproportionate". However, we recognise that guidance confirming that sustainability risks should be considered alongside other risks may be helpful. We believe there are two areas that need further clarification and recognition:

1. ESMA needs to provide further clarity on what ESG factors always have to be considered by investment firms, or only in instances where ESG considerations are relevant, for the provision of investment services provided by particular clients.
2. The consideration of ESG factors requires the availability of ESG data, which lacks uniformity – although is improving. It is important for ESMA to recognise this, and in line with the high level principles, not promote requirements that will force firms to rely on imperfect third party data.

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.

We see the inclusion on conflicts in the recitals as inappropriate particularly as the expectation in the CP is to make firms reference in their policies as to how these conflicts are managed. Therefore we do not see a requirement for a new provision.

We also question the process of placing this in the recitals, but providing guidance in the CP, without going through Level 1. In addition, firms are asked to provide their own definitions, which would seem counter to ESMA's statement (p.9) "*singling out sustainability risks (amongst the various risks that are relevant for firms) is unnecessary to achieve the Commission's objectives and would be*

disproportionate”, meaning that if conflicts policies are sufficiently robust why would there be a need for a special mention. It should be covered in any event as part of a broader conflicts regime.

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.

We do not believe any further amendments need to 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.

We recognise market-specific labels for sustainable investment products, however these do not have pan-European or global market appeal. Similarly we see divergence in the sustainability assessments of the companies we review. Based on our external research and internal analysis we do not recognise a ‘market standard’ as described by ESMA.

To offer a few examples:

- The fund-level domestic/national eco-labelling schemes (Label ISR, TEEC Label (France); FNG Siegel (Germany); Luxflag Climate Finance Label (Luxembourg); Swan Ecolabel (nordic countries)) outlined in the consultation paper are national. There are no pan-European labels. A number of our funds are accredited to the French SRI labels – these are well understood and popular within the French market. However, these labels do not resonate outside the national market.
- HSBC Sustainable Financing and ESG Investing report¹ surveyed issuers and investors globally in 2018 looking at barriers to sustainable finance. Our research showed us that identifying sustainable assets is a barrier for issuers and investors. A positive for the market is that 66.6% of issuers and 57.1% of investors respectively stated there are no barriers to increasing their ESG commitments. However, of those that do see barriers, inconsistency of ESG definitions was seen as the number one barrier for 72.8% of issuers and highest for both issuers and investors.
- Our own internal analysis of ESG vendors reaches a similar conclusion that, beyond carbon emissions (scope 1, 2 and 3), it is very difficult to find ESG data that is independent and uniform. We are of the view that it is unlikely that ESG ratings from the traditional providers will converge enough to represent a uniform assessment of overall ESG performance; however, we may see greater uniformity from Credit Rating Agencies. Further, an investment firm’s assessment of sustainability risks and opportunities, derived from external data and/ or internal analysis, can generate value for clients, just as an investment firm’s financial valuation of a stock. Certain variability in assessment is therefore likely to continue.

Our recommendation therefore is for ESMA to recognise in their advice to the European Commission that this market does lack uniformity and comparability, and therefore a policy stance relying on the existing standards and labels would not provide a firm footing for future work.

¹ HSBC Sustainable Financing and ESG Investing report <https://www.hsbc.com/news-and-insight/2018/esg-becomes-a-priority>

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 approach proposed would require substantial changes to a firm's systems and operations and we urge ESMA to allow sufficient time to allow for this transition.

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.

No answer provided

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

No answer provided

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.

The most material ESG factors, and relative importance of these factors, are dependent on a range of characteristics such as sector, country, product and these are constantly evolving. We therefore look at environmental, social and governance issues individually and in aggregate. We recognise also that for certain investment strategies, one of the factors will be the explicit area of focus, for example in the case of green bonds.

A very specific definition of ESG assessment, would not be widely applicable across products and strategies or beneficial to clients.

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 refer to Q5 for our view on whether a market standard exists for ESG factors.

More broadly some of the taxonomies, standards and definitions we do reference include, but are not limited to, Green Bond Principles, Green Loan Principles, Equator principles, FSB Task Force on Climate Related Disclosure (TCFD), UN Sustainable Development Goals, Global Sustainable Investment Alliance definitions and the Principles for Responsible Investment definitions in their reporting framework.

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 note ESMA has requested firms to specify methodological approaches and has included two portfolio based advisory examples in approaching suitability assessment incorporating ESG preferences. While we welcome the principle-based approach to avoid overly prescriptive terms in regulatory guidance, we would like to seek clarity on cases where portfolio based advisory is not achievable, for example for clients who have a preference in ESG and/or other specific preferences but cannot afford multiple holdings. This is particularly critical for asset classes where ESG product coverage is limited.

The Bank has a fiduciary duty to ensure product recommendations meet clients' financial suitability (including risk profiling, investment objectives, financial situation, etc). For example, for clients who do not have sufficient net worth for multiple investments, a multi-asset investment fund which provides diversified exposures at reasonable costs and minimum investment amount may be recommended. Considering ESG preferences are only assessed as a second step after financial suitability assessment, we are conscious there will be circumstances where none of the available ESG products can meet a client's financial needs and their ESG preferences at the same time. In this case, we consider that a non ESG product that fits a client's financial circumstances will be suitable and can therefore be recommended to the client, even though the product does not meet the client's ESG preference. We hope this aligns with ESMA's suggested approach.

More broadly, we are increasingly concerned by the statement that *"Until an unified EU classification is finalised, investment firms should clearly specify what they consider to be ESG preferences or ESG considerations, while taking into account current market standards."* We question the rationale of firms potentially having to implement these factors into their systems, controls and processes twice – when there could be major differences between a firm's approach to ESG and the EU's final Taxonomy. A hasty implementation may create more confusion, especially for clients, particularly as there is a lack of a consistent market standard, and before the Taxonomy is to be finalised by end 2022. For this reason, we call upon ESMA to consider in its technical advice to the Commission the idea of separating its work on ESG under MiFID II from the Taxonomy. We argue this for the very simple reason that the work of the TEG is not taking a high level principles-based approach to its work, instead seeking to provide sector definitions of "sustainable economic activities" and we are therefore concerned that ESMA's work on ESG may be incompatible with the current direction of the TEG's work on taxonomy.

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.

Please see our answer to question 9 which states ESG should be treated as a whole.

Within this section ESMA refers to "Good governance investments". It is not clear what ESMA means by "good governance", or for that matter what "bad governance" investments may be, so clarity here would be welcome.

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

While we would be supportive of a proposal to incorporate ESG preferences within a client profile, it needs to be introduced gradually as it would require a complex, likely multi-year project to be implemented.

Specifically we would welcome ESMA to provide:

- Guidance on the appropriate level of disclosure a firm should provide to explain its approach to ESG. This could include internal governance and control functions / internal policy framework to be disclosed. We note the Principles for Responsible Investment may provide a useful reference framework.
- A minimum 12 month review clause after the entry into force to assess the progress and implementation of the recommendations, with consideration of the right balance between providing refined guidance on definitions and additional costs and resources required by firms to implement changes twice.

We believe the above measures would limit a hasty implementation and reduce confusion especially there where there is a lack of consistent market standards.

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 per our comments to question 11, there would be significant costs involved if firms are required to implement first based on ESG factors and then again once the EU's taxonomy is agreed.