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European Supervisory Authorities

Electronic submission

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ESMA-EBA-EIOPA (ESAs) Joint ESA Consultation paper – ESG disclosures

UK Finance is the collective voice for the banking and finance industry operating in the UK. Representing more than 250 domestic and international banking and finance firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. We consider it appropriate to respond to the joint ESA consultation as we view the issues raised as having relevance both in terms of changes that might be expected to be seen in the UK regime given the case for continued broad alignment and the relevance of the EU regime to many of our member firms.

The Covid-19 crisis has brought into vivid focus the importance not only of environmental objectives, but social and governance goals. Improved ESG disclosures on the part of businesses and other organisations can be a significant contributory factor to this. UK Finance agrees that currently reported ESG information is insufficiently comparable or reliable and are supportive in concept of the intention behind the ESAs review, but have many concerns with the content and timelines in the consultation.

We have summarised our concerns and related comments below.

Linkages to and divergence from other ESG and related developments

The EU Regulation on Sustainability-related disclosures in the financial services sector (SFDR) is inextricably linked to other developments within European Union on ESG matters but appear to be inconsistent with the level, scope and implementation timeframes relevant to these other regulatory developments.

In general, a more flexible and principles-based approach is needed, as outlined in the SFDR L1 text (EU) 2019/2088. Mandating the adverse impact across entities is likely to be contrary to what is required and described as adverse impacts at the product level.

There are multiple related regulatory developments that impact ESG requirements that will be amended or implemented over the next 2 to 3 years. It is therefore challenging to ensure consistent and effective implementation. Some of our concerns and issues are discussed below:

- **MiFID (Markets in Financial Instruments Directive) II**:
    - The draft text amending the integration of ESG considerations and preferences in investment advice and portfolio management became available in January 2019 and consulted on in May 2020. However, these amendments have not yet been adopted by the European Commission. Once these delegated acts are published and in force, there will be a 12-month period prior to local application. During this period the ESAs will develop technical standards to clarify what and how information should be disclosed. As the MiFID ESG amendments

on product governance and suitability have not been published, client ESG preferences will not be captured or available by March 2021, the proposed effective date of SFDR implementation, and only likely at the end of 2021.This would make it impossible for firms to disclose suitability statements on meeting or achieving customer ESG goals, initially and periodically.

  - SFDR does not make the same distinction between manufacturer and distributor as in MiFID, it captures activities that are broader than individual products. At the moment, wealth management firms are considering what sustainability preferences they should collect from their clients and trying to build or enhance their suitability frameworks (as per MIFID II sustainability requirements), but it is difficult to know the level of granularity required when it is not clear the level of granularity of data product manufacturers will be disclosing. investment firms are waiting on the ESMA Guidelines on MIFID II Product Governance to be updated on suitability.
  - It is also uncertain as to the level of granularity issuers will go to for target market. Firms do not know if the proposed definition of 'sustainability preferences' in the draft MIFID II delegated regulation will be effective. It cross-references Disclosure Directive definitions – so the two are tied on this point.
  - There is a significant level of interconnectedness with evolving data availability in the market regarding products and data that should be collected from clients regarding their sustainability preferences. This significantly increases the risk of potentially implementing inappropriate and uncorrelated data processes and protocols due to the timing and scope differences.

- **PRIIPs (packaged retail and insurance-based investment products):**
  - The ESAs' rejection of the draft PRIIPs key information document (KID) RTS, blocking the informal compromise between ESMA, the Commission and the European Parliament, due to concerns with the proposed changes to the cost disclosure framework, will further delay amendments to PRIIPs and overlooks the expectation that changes will be needed to the PRIIPs regulation to accommodate the SFDR requirements on pre-contractual disclosure.
  - Similar challenges exist for implementing requirements of the UCITs, AIFMD, Solvency II and IDD delegated acts when final versions are published in Q3 / Q4 2020.
- **EU Taxonomy**:
  - Disclosure against the Taxonomy forms part of a broader sustainability-related disclosure regime with which financial market participants are expected to comply. Whilst the taxonomy does not create obligations, once public, there will be an expectation and conduct imperative to ensure that firms' internal definitions align and that firms face adverse comments on greenwashing for example if internal processes for defining at least the "Environmental" of ESG do not align.
  - These broader disclosure obligations are laid out in the SFDR. The Taxonomy is relevant for the qualification of products for example light versus dark green. Furthermore, we would like to see clarifications on the overlap between the Taxonomy's "do no significant harm" (DNSH) criteria and the Principle Adverse Risk Impacts from the Disclosure Regulation.
- **NFRD (Non-Financial Reporting Directive)**
  - The NFRD is still under revision and consultation, reporting of non-financial data is not compulsory and those that report do so flexibly, choosing the most useful way e.g. UN Global Compact, OECD Guidelines etc.

- The NFRD aims to provide data for investment decisions but both the Disclosure Regulation and proposed Taxonomy Regulation can only meet their objectives if relevant non-financial information is available from investee companies. Therefore, the scope is too limited or not widely established for our members who are portfolio managers to be able to disclose anything about most companies with any certainty or rigour. There is also a requirement under NFRD to comply DNSH criteria and minimum safeguards

- **TCFD:**
  - In June 2019, as a supplement to NFRD guidelines, EC published guidelines on reporting climate-related information which integrates the recommendations by the FSB's Taskforce on Climate related Financial disclosures (TCFD).
  - These guidelines are voluntary, have been implemented with differing timescales and strategic paths as well as low take-up by non-financial companies leading to lack of comparable, decision-useful data for financial institutions.
  - This may hinder robust climate related disclosures under this proposal until well embedded over the next few years.

- **Sustainable finance EU Strategy:**
  - The EC's renewed sustainable finance strategy is currently in consultation. The objectives are to increase private investment in sustainable projects and activities to support the different actions set out in the EU work programme and particularly the European Green Deal; help more individuals and firms (financial and non-financial) to make an impact by increasing opportunities for sustainability: "financing green"; and manage and integrate climate and environmental risks into financial firms and the financial system "greening finance". These objectives need to be addressed before or at least alongside any detailed Sustainability disclosures focussing on adverse impacts

- **Sustainability risk and factors**
  - An extensive list of sustainability risks and sustainability factors should be forthcoming from the EC so that all financial markets participants have an adequate initial guidance as to what to observe and to assess
  - Are the draft regulatory technical standards to be produced by the ESAs by December 2020 deemed to be offering such a guidance about what sustainability factors to include in order to be able to assess the risks of the principal adverse impact of such factors stemming from investment management decisions?
  - Product governance and target market policies of manufacturers and distributors - Further guidance is needed as to how to incorporate sustainability factors in such policies

Timelines and scope

- SFDR comes into effect, with some exceptions for specific articles on 10 March 2021. The delegated acts setting the standard for the regulatory technical standards (RTS) for SFDR will be based on the final recommendations by the ESAs. The draft RTS that can assist financial market participants to apply and comply with these disclosure requirements is to be submitted to the European Commission in December 2020 and then go through a non-approval process prior to being finalised and published less than 3 months before the effective date of SFDR - an extremely tight deadline. It is also assumed that Table I in Annex I of the draft RTS will come into force on 10 March 2021 for entity level website disclosures under Article 4(1)(a) – the information required is very comprehensive and detailed, also quite challenging to gather by 10 March 2021. This leaves very little time to implement the significant array of changes to systems, processes

and governance protocols that would be essential before the publication of such required disclosures. Financial institutions will need to assess the SFDR systems/procedures in place for March 2021 in line with the changes introduced as a result of the upcoming MiFID requirements where details are not finalised.

- The timeframes mean that FMPs/FAs are required to initiate programme, process and system changes in advance of the publication of the final RTS which may have requirements that are different to the draft. This will lead to inefficiencies and resources focused on last minute system changes and hence prone to error.

- Considering the other regulatory developments that impact ESG requirements over the next 2 to 3 years also significantly increases the risk of potentially implementing inappropriate and uncorrelated data processes and protocols due to the timing and scope differences.

Customer perspective – Fair, Clear and Understandable information

- Level of detail of disclosure required in SFDR is, we believe, not supported by customer research on whether this will be understandable to the EU retail investor.

- Retail investors will not understand the materiality and level of detail as required in the RTS. Information for retail investors should be fair, clear and not misleading. This cannot be achieved with the format and disclosure requirements as contained in the RTS. We suggest a focus on a more limited number of indicators.

- This collation of data leads to higher costs which may be passed on to the customer.

- From a customer perspective it would be necessary to evaluate the correlation between ESG and 'ordinary' risk/return characteristics of products and objectives of clients. How ESG preferences can be related and/or compared to the financial interests and goals of retail investors in assessing the target market should be a key determinant in the regulation of ESG disclosures. Which would prevail in the context of a discrepancy for a retail investor: financial objectives or sustainable objectives?

- It is not clear how firms can in practice only offer 'sustainable' (i.e. art. 8 and art. 9) products to customers who have, at a very high level only, indicated their sustainability preferences. Or can mainstream products also be distributed to clients who have indicated sustainability preferences, because they are suitable based on other (financial) preferences? Further guidance is needed as to how to incorporate sustainable investments or those that promote environmental or social characteristics in such policies. Also see "Information level".

- The opt-in regime for additional climate and other environmental related indicators (Table 2) and social and governance matters (Table 3) suggested by this regulation is not likely to be useful to end retail investors. In practice, firms will not disclose the same opt-in indicators in Table 2 and Table 3 so investors will not have comparable or consistent information to make their financial investment decisions.

- There is a general insufficient availability of relevant data on investee companies, especially for private equity, to make adverse impact disclosures. A central database may drive consistency and reduce costs.

Information level

- Sustainability risks must be taken into account when complying with organisational requirements and the integration of sustainability risks in risk management policies. There is currently no formal standard or guidance as to how sustainability risks should be integrated into risk policies.

- Differentiation should also be made between risk policies at the investment management level and the level of risk that is tolerated at a firm level. These would play a part in the determination of entity level and product level disclosures contemplated by this regulation. We do not consider that the disclosure at entity level is sensible. We would suggest adverse impact assessment at product level. The RTS has only placeholders for the product level disclosures. As yet there are no requirements.

- It is also unclear how the assessment of outsourcing to third parties may be considered.

- Further guidance is needed as to how to incorporate sustainable investments or those that promote environmental or social characteristics in such policies. A single indicator is more or less comprehensible, simple and meaningful to implement. Specifying E, S and G considerations separately (and thus more granular) will be complex for both distributors, product manufacturers and clients and will require a granular set of rules on how to deal with conflicting sustainability preferences of clients. Furthermore, we believe this might lead to investment products that are more skewed to a certain topic, and therefore impose more risk. The aggregation of principal adverse impact indicators at entity level is not going to be helpful for end-investors.

- The level of information required to complete Table 1 Annex 1 of the RTS is quite granular and detailed. In the majority of the cases, the information is held or controlled by different FMPs (manufacturer, fund manager, data provider etc.). It is not clear how the information will be gathered and/or who is ultimately responsible for ensuring its accuracy. This is particularly challenging for multi-option products. For example, would it be acceptable to redirect the customer to the fund manager's website or provide a link to the statement from the fund manager?

Specific questions and observations

We also have some specific questions and observations:

<u>L1 Text</u>

Art 5 – FMPs are also required to disclose how due diligence policies are consistent with the integration of sustainability risks in the context of their remuneration policies.

- Does the term 'remuneration' also include commissions/fees paid to third parties, for example commission paid to distributors etc?

Art 8 & 9 - *There is a distinction between products which 'promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics' and products which 'have sustainable investment as [their] objective'*. It is not clear how to divide products into these two groupings - there is no definition of 'promoting environmental characteristics' or 'promoting social characteristics' and there is no definition of 'having sustainable investment as objective'. In order to be clear which products fall into each of these groups (and which products fall outside of these groupings), these terms need to be defined.

- Given the wording of Level 1 Article 8, it seems that a product which has environmental or social characteristics can either promote those characteristics or not. In order to understand the bucket better, there is also a need to understand what 'promote' is trying to capture and when a product which has environmental/social characteristics is also promoting those characteristics.
- Level 1 Article 10.1.c and 10.1.d mentions to include the information in periodic reports and pre-contractual disclosure. Does this mean just a statement needs to be included that its available in these documents? Or all the information required in Articles 8, 9 and 11 are supposed to be available in the product level website disclosure?
- Also see "Level 2 Article 14"

Art 7 - of Level 1 RTS does not have any Level 2 guidance as to how a financial product considers principal adverse impacts on sustainability factors, and this is due by 330 December 2022.

- However, Chapter 3 of Level 2 RTS (Art 18, 27) expects to publish on the pre-contractual disclosures the list of sustainability indicators used to attain the sustainable investment objective or social or environmental characteristics promoted by the product (due by 10 March 2021).
- How different is the expectation between Level1 - Art 7 and Level 2 – Art 18,27 - will there be additional guidance in the final RTS?

RTS L2 Text

Art 2 – states that "*Financial market participants shall provide the information referred to in this Regulation in a manner that is non-discriminatory and in searchable electronic format*". It would be useful to understand whether electronic format is considered 'non-discriminatory', how many investment options would be needed before we feel a search option is necessary and what is intended by searchable?

- states that "Financial market participants shall keep the information published on their websites in accordance with this Regulation up to date. They shall include the date of publication of the information and clearly identify any updated text with the date of the update." How is up-to-date defined and how do firms practically make updated text identifiable, especially for existing documents?

Art 4 - states "*that the information on due diligence policies be disclosed under a section 'Adverse sustainability impacts statement' which will be displayed under a new section 'Sustainability-related disclosures' in the same part of the website where the other information relating to the financial product, including marketing communications are located".*

- Is 'Adverse sustainability impacts statement' a clear and understandable sign-post for the customer? This requirement to disclose a 'Description of principal adverse sustainability impacts' which requires the completion of a very detailed assessment set out in the Annex to the RTS - The requirements here are both very granular, cover a lot of different areas and may end up being very unclear to clients.
- For example, how exactly is 'share of energy from non-renewable sources used by investee companies broken down by each non-renewable energy source' measured and disclosed?
- What does 'untreated waste-water discharged' in 'total amount in cubic square meters of untreated waste water discharged by the investee companies expressed as a weighted average' mean? And what is a 'workplace accident prevention policy' in the 'share of investments in investee companies without a workplace accident prevention policy'?
- The risk with all of these individual requirements is that what seems clear in the draft becomes less clear once firms are actively looking to complete the data and that the information is not comparable across firms as different firms interpret the requirements differently.
- These requirements rely on the FMP having a lot of information available about investee companies - not all of which will be available publicly (especially by non-EU investee companies). There is a challenge in retrieving accurate information.
- There is a lack of clarity around the 'investee company' – if a portfolio or fund holds equities and bonds issued by different entities within a group structure, is the FMP looking at the actual issuing company of the relevant security as the investee company or at the group as a whole?
- From a data perspective, is the kind of data required available at the level of individual group entities, even where consolidated accounts and other reports are prepared at a group level?

- Both the Level 1 text and the draft RTS do not address the position of FMPs who have delegated their management activities to third parties. A credit institution may have delegated investment management for clients to one or more third parties. All of the delegates will themselves (if based in the EU) be FMPs. In this scenario, the Article 4 entity level disclosure by the FMP which does not in itself actually perform the management activity will need to be an aggregation of data provided by its delegates. While there can be a contractual obligation for delegates to provide the data, there remains a larger question as to the purpose of the aggregation and whether the entity level disclosure of the delegating FMP would really assist clients.

Art 6 - states "*to disclose the measure of the principal adverse indicators at the entity level, of which at least one social and one environmental indicator has to be chosen which is deemed 'principal'*. Also, it asks to include any other adverse impact on a sustainability factor that qualifies as 'principal'." How is principal defined?

Art 7 - asks to include "*allocation of responsibility for the implementation of the policies within organisational strategies and procedures, methodologies and data sources used to assess the principal adverse indicators"*. Is there any further guidance anticipated on this?

Chapter 3 of Level 2 RTS provides guidance on how FMPs should publish on their pre-contractual documents the integration of sustainability risks into their investment decisions, and what is the impact of these risks to the return of the products. However, there is no guidance on how FAs will publish this information, although requirements in the L1 RTS for the FAs are the same as FMPs.

Art 12 "*Financial advisers shall publish the information referred to in Article 4(5)(a) of Regulation (EU) 2019/2088 on their websites in a separate section titled, 'Adverse sustainability impacts statement'. The statement shall contain details on the process to select the financial products they advise on, including the following*

- *how the information published by FMP in accordance with this Regulation is used;*
- *whether the FA ranks and selects financial products based on the principal adverse impacts and, if so, a description of the ranking and selection methodology used;*
- *any criteria or thresholds used to select financial products and advise on them based on those impacts."*

- According to Level 1 Article 4, an FMP is only required to disclose the principal adverse impact on an aggregate position, which does not tell each of the product position.
- *Product level* principal adverse impact disclosure will not be mandated until end-December 2022, before this therefore we do not expect FMP to be disclosing principal adverse impact in pre-contractual disclosure. Incomplete disclosures from different FMPs will make the product selection process challenging, if not potentially biased and misleading based on estimation, adding complexity while arguably not added value to the advice process which also considers investors' financial objectives, risk tolerance, preferences and now including sustainability risk integration as per SFDR requirement.
- It is important to clarify the expected timeline. Without complete and available pre-contractual product disclosures, FAs will be unable to consider sustainability adverse impact in the product selection and product advice process

Art 14 *requires "the information below in the pre-contractual document*

(a) 'Environmental or social characteristics promoted by the financial product';
(b) 'No sustainable investment objective';
(c) 'Investment strategy';
(d) 'Sustainability indicators';
(e) 'Use of derivatives';

(f) 'Website reference'; and
(g) if an index has been designated for the financial product as a reference benchmark, 'Reference benchmark'."

- It is unclear how this level of detail will fit in with the PRIIPs KID requirements?
- Article 14 para 1b and Art 16 "no sustainable investment objective": This sentence could be confusing for retail investors. If a product is designed to promote E/S characteristics, it would be counter-intuitive to retail investor that it has no sustainable investment objective, although it may not fit the EU taxonomy definition of sustainable investment.

Art 19 - Derivatives are typically used in hedging portfolio or manage portfolio in an efficient manner to deliver its objective (mostly financial) and are not particularly designed to achieve E/S objective or characteristics. Guidance is needed what kind of derivative or the conditions/thresholds of using derivatives can be considered sustainable or unsustainable

Proportionality

- Factors such as firm size, depth of local markets, ability to finance the investments required, overall market maturity which are not the same across Europe and across the world will need be reflected in the regulations. For smaller financial institutions, it will be costly to implement these and other similar disclosure requirements.

- Quality and availability of data is fundamentally important for this regulation to be implementable and successful. The disclosure obligations created by this regulation and other similar regulations will require access to data providers.

Conclusions and recommendations

- Rigorous and consistent application of these disclosures may be more likely if there is alignment of this regulation with the scope and timelines of other ESG and related developments, including the Sustainable Finance Action Plan. The legislative framework for various elements of ESG proposed by the EC is very complex, with many different pieces of legislation with compressed timelines and affecting different groups, with added Guidelines and Reports from the ECB and the European Supervisory Authorities. Implementation is further complicated by poor sequencing and overlapping of requirements, for example on disclosure as the case with this consultation.

- Further guidance is needed as to how to incorporate sustainable investments or those that promote environmental or social characteristics in such policies. A single indicator is more or less comprehensible, simple and meaningful to implement. Specifying E, S and G considerations separately (and thus more granular) will be complex for both distributors, product manufacturers and clients and will require a granular set of rules on how to deal with conflicting sustainability preferences of clients. Furthermore, we believe this might lead to investment products that are more skewed to a certain topic, and therefore impose more risk. The aggregation of principal adverse impact indicators at entity level is not going to be helpful for end-investors.

- Whilst an impetus is needed to drive consistent disclosure, changes to disclosure regimes should be simplified wherever possible. There needs to be a balance between the need for a comprehensive approach to the development of and the implementation challenges that a complex raft of new and overlapping measures - for example on ESG disclosure - can cause. There is also a case for a phased approach to regulatory change and customer education to support.

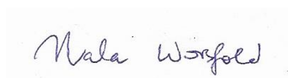
- Any strategy should align the interests of issuers, investors and intermediaries, especially in designing the framework for disclosure.

- Phasing-in of a one set of consistent key indicators that are meaningful, understandable and capable of consistent application by a majority of FMPs would be more beneficial for end investors.

- The ESAs should consider the approach that the Financial Stability Board took with enhancing banks' risk disclosures in 2012. The approach was voluntary and included a collection of recommendations based on actual good practice across the globe and implementation though the rigours of combined investor and preparer outreach supplemented by regulator focus. This resulted in market leading implementation, particularly by major banks in UK and Canada over a 3-year horizon.

I and UK Finance members would be happy to discuss the content of this response with the ESAs.

Yours sincerely



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