

POSITION PAPER



ESMA Consultation paper on integrating sustainability risks and factors in MiFID II

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General comments

We welcome the publication of the European Commission's *Action Plan: Financing Sustainable Growth* as sustainability is core to the values of our members.

However, we would like to express our concerns about the timing. Not only is the absence of a clear view on the outcome at Level 1 on sustainable finance legislation (including for the taxonomy and the disclosure framework) challenging, but the lack of legal definitions (sustainability risks, or factors, and sustainable investment), makes integrating sustainability risks and factors problematic, both from a Better Regulation and implementation point of view. The adoption of the taxonomy will only clarify the integration of some environmental considerations. However, the integration of other factors and risks (social and governance) will continue to be challenging.

We agree with the general principle that assessing the impact of investment on sustainable factors is desirable. However, a lack of common definitions, methodologies and guidance on how to capture the effects of investments on sustainability factors, makes it difficult to examine and evaluate these factors. We would like to emphasize that the legislator should ensure clarity and legal certainty.

- **Question 1: 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.**

We agree, that where ESG considerations are relevant for the provision of investment services to clients, firms should take them into account. Nevertheless, we consider that the proposed changes to Article 21 of the MiFID II Delegated Regulation are unnecessary, as this article already takes into account ESG considerations. Complementing ESG considerations would therefore only be justified if ESG considerations were subject to more specific requirements. However, this does not seem to be the case. Rather, ESMA emphasises that ESG considerations are relevant with regard to the suitability of a recommendation (investment advice) or investment decision (financial portfolio management). In this respect, the ESG considerations with regard to Art. 21 MiFID II Delegated Regulation are subject to the same provisions as the suitability criteria already applicable today.

Since an explicit mention of ESG factors would thus merely clarify the situation, we advise against including this amendment. It would be misconstrued as meaning that ESG factors are more important than other factors.

- **Question 2: 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.**

We agree, that investment firms should take into account environmental, social and governance factors if they are relevant for risk management policies and procedures. Nevertheless, we consider that the proposed changes to the Article 23 of the MiFID II Delegated Regulation are unnecessary. According to Art. 23 (1) (a) of the MiFID II Delegated Regulation investment firms shall "establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities,



processes and systems, and where appropriate, set the level of risk tolerated by the firm". As such, Article 23 already takes into account ESG considerations if they are material.

Complementing ESG considerations would therefore only be justified if ESG considerations were subject to more specific requirements. However, this does not seem to be the case. Rather, ESMA emphasises that ESG considerations are relevant with regard to the suitability of a recommendation (investment advice) or investment decision (financial portfolio management). In this respect, the ESG considerations with regard to Art. 23 MiFID II Delegated Regulation are subject to the same provisions as the suitability criteria already applicable today.

Since an explicit mention of ESG factors would thus merely clarify the situation, we advise against including this amendment. It would be misconstrued as meaning that ESG factors are more important than other factors.

- **Question 3: 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?**

Existing requirements for dealing with conflicts of interest cover all types of conflicts of interest: All potential conflicts of interest mentioned by ESMA in paragraphs 12 et seq. are already taken into account within the framework of conflict of interest management for investment advisory and asset management services.

There does not seem to be any particularities regarding ESG considerations that would justify specific provisions.

We therefore advise against introducing the proposed new recital 59. Conflicts of interest which may arise from the distribution of ESG investments are already taken into account, if they are relevant. Therefore, we recommend not to include this clarification to recital 59. It could be misconstrued as meaning that conflicts of interest arising from the distribution of ESG investments could be more important than other conflicts of interest. Alternatively, introducing "where relevant" in the proposed recital could be a possible option.

- **Question 4: 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 amendment to the organizational requirements in the MiFID II Delegated Regulation is necessary to ensure the effectiveness and adequacy of sustainability risks and factors.

- **Question 5: 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.**



Currently, a lack of common market standard that capture all relevant ESG factors in a suitable way implies that entities use a wide range of different labels, with different scoring and scales. This situation makes comparison difficult or impossible for customers.

We therefore see the adoption of a common taxonomy on environmental, social and governance issues is a step forward. In our view, it would make sense for the European legislator to set a (minimum) standard that product manufacturers or certification bodies can use.

According to the proposal, the ESG factors should also be included in the target market, so that they should also be taken into account in the target market assessment. This will require a high degree of standardization so that issuers and distributors share the same understanding of ESG factors. Without such standardization, it is to be feared that customers will be provided advice that is not in line with their preferences (since the distributor would have a different understanding of the product from the issuer). Such standardization would also be in the investors' interest as it would increase transparency and comparability. We therefore regard the adoption of a common EU taxonomy as a step forward. Until this is the case, ESMA should provide for a mandatory minimum standard.

In addition, ESMA should also encourage manufacturers who declare their products to be sustainable to draw attention to this aspect in the information sheets provided by law. For example, does Article 8 (3) (c) (2) of the PRIIPs Regulation provide that the environmental and social objectives pursued by the product are listed under the heading "What type of product is it?". In this context, we would like to 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 either organic or social, is not yet available. It is therefore imperative that the Level II act provided for in the PRIIPs Regulation be the basis to provide manufacturers with a legal framework for product classification prior to the finalization of the Taxonomy Regulation.

With regard to funds, ESMA should also encourage that capital management companies which propose products as sustainable must also refer to this in the UCITS / AIF KIDs. For example, Article 7 of Regulation (EU) No 583/2010 (KID), which sets out the objectives and investment policy of the Fund, could include with such a requirement.

- **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.**

Without a common taxonomy, we support ESMA's position on integrating ESG preferences with the MiFID II requirements through a high-level principle-based approach. For this reason, we are in favour of linking ESG preferences only in those cases that are relevant. We see, however, some advantages to this inclusion, including a limitation of the distributor's liability.

However, it is important to take into account the particularities of the target market criterion of sustainability for its inclusion in existing product governance frameworks. We still see room for improvement here (for the details we refer to our answer Q 7).



Furthermore, ESMA should propose a period for the implementation of additional product governance requirements. Take into account technically challenging adaptations (provision of the manufacturer's target market data for the distributors; adaptation of the IT-supported mapping processes of the distributors), an implementation period of 18 months from publication of the legislative text in the Official Journal is necessary. This period should be added within the ESMA draft.

- **Question 7 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.**

Overall, the proposed adjustments are positive. In our view, however, the characteristics of the target market criterion should be outlined more clearly. At the same time, some points in the Guidelines should be supplemented to take account of the particularities of the target market criterion of sustainability. These include the following aspects:

a) Practical design of the target market characteristics

The main issue pertains to the fact that the taxonomy is still being developed and there are currently no legal guidelines on how a manufacturer should evaluate the sustainability of its product when the new product governance requirements will come into force. This distinguishes the new target market criterion from other criteria, such as client category or the risk/reward profile, for which legal provisions exist, on which manufacturers can base the target market definition (client categories under MiFID II or PRIIPs-SRI).

In order to achieve a certain standardisation in the case of the new target market criterion, in spite of the lack of corresponding guidelines, ESMA should provide information on the target market characteristics. Otherwise, it is to be feared that the approach pursued by the Guidelines on Product Governance (see Guideline 16 of the ESMA Guidelines on Product Governance) cannot be achieved in the case of the ESG criteria.

At the same time, it has to be acknowledged that the extensions currently preferred for the suitability assessment and product governance are only a first step. In this respect, if ESMA decided in favour of implementing changes to the target market criterion before the finalization of the taxonomy, a high-level approach should also be preferred for the target market characteristics (at least as a first step). In our view, the target market criterion should be described in the following way until legal requirements are implemented:

- Sustainable: Yes (the product is declared to be sustainable by the manufacturer)
- Sustainable: No (the manufacturer has not declared the product to be sustainable).

Concerning the negative target market, we refer to our remarks below under d).

In view of the lack of a taxonomy, further characterisations would lead to IT implementations, which within a short time would no longer correspond to the new legal requirements. This would mean that investment firms bear a double burden of very high implementation costs. This would be contrary to the principle of proportionality, which is very strongly emphasised precisely in relation to product governance (see Guideline 11 of the ESMA Guidelines on Product Governance) and should be avoided at all costs.

b) Assistance for manufacturers in the classification

In view of the lack of a taxonomy, there is great legal uncertainty for manufacturers as to when they can declare a product to be sustainable. Some manufacturers are currently refraining from declaring their product to be sustainable due to potential liability risks.

For manufacturers which are subject to MiFID and therefore in future will be required to classify their products with regard to sustainability in the target market definition, guidance from supervisory authorities is necessary until a legal framework is in place. ESMA should therefore stipulate in the Guidelines or in the Final Report that the determination of the target market criterion of sustainability can occur, for example, through certification by independent certification bodies (such as the certification bodies listed in footnote 6).

Such a clarification would clearly boost readiness to declare products to be sustainable. Otherwise it is to be feared that manufacturers will continue to be reluctant to declare their products to be sustainable, which may lead to the distributors being unable to offer any suitable products to their clients with sustainability preferences. The aim pursued by the legislator of strengthening sustainable investments would therefore fail. In this respect, ESMA should provide information in the Final Report so as to reduce legal uncertainty with respect to the taxonomy.

c) Linking to manufacturer information

In order to provide clients with greater transparency, ESMA should include the indication that a manufacturer which declares its product to be sustainable in the target market should also do so (as far as possible) in the relevant product-related information documents. Here, synchronisation between the information provided by the issuer to the distributor (as machine-readable data) and the information used to describe its product in the relevant product information document is essential:

- In the key information documents under the PRIIPs Regulation, a reference appears under the heading “What is this product?”, since in Article 8(3)(c)(ii) of the PRIIPs Regulation, this provision is already used as an indication whether a product pursues environmental and social objectives (this opportunity should be taken by the European legislator, however, to adopt the delegated act provided for in Article 8(4)).
- In the case of investment funds, a corresponding reference could be included under “objectives and investment policy” in the key investor information document.

d) No negative target market

It is very positive that ESMA stated in the Consultation Paper that a positive declaration of the target market suffices and a negative differentiation via the negative target market is not necessary (see CP p. 14, point 10).

In our view, however, this aspect should also be stipulated directly in the Guidelines. For example, a corresponding reference could be considered in Guideline 68 of the ESMA Guidelines on Product Governance that no negative target market has to be defined with respect to sustainability.

e) Restriction to investment advice



In the Guidelines on Product Governance, ESMA correctly acknowledges that without provision of investment advice, distributors can consider only the target market criteria of clients' knowledge and experience (see in particular Guideline 45 of the ESMA Guidelines on Product Governance).

ESMA should include a reference in the Final Report to the fact that sustainability preferences does not have to be processed in the case of orders without investment advice or in execution only. This already results from the fact that sustainability is a characteristic of the target market criterion of client objectives and needs. For reasons of legal certainty, we should nevertheless welcome explicit clarification in the Final Report.

f) Synchronisation with the suitability assessment

In the passage concerning the suitability assessment, ESMA correctly points out that a sustainable product which is sold to a client without ESG preferences is not *per se* unsuitable for the client. Conversely, a product declared as not sustainable need not automatically be unsuitable for a client with ESG preferences.

This correct evaluation concerning the suitability assessment should also apply for the target market assessment:

- ESMA already correctly stated in the Consultation Paper that the sale of a sustainable product to a client without ESG preferences does not represent non-compliance with the target market (CP p. 15, paragraph 13).
- Conversely, it should be stated in addition that the sale of a product declared not to be sustainable to a client with sustainability preferences is also possible with appropriate justification.

Both aspects are tremendously important in practice. This is particularly the case for the latter aspect, given the fact that in view of prevailing legal uncertainty, manufacturers could refrain from declaring their products to be sustainable. It should be made clear that distributors can nevertheless recommend investment products to their clients.

In this respect, the possible two-stage approach proposed for the suitability assessment should also be transferred to the target market assessment. Furthermore, this aspect should be stipulated in the Guidelines themselves and not only in the Final Report. A supplement could be considered here to Guideline 70 of the ESMA Guidelines on Product Governance.

g) Consequences for the feedback regime to the manufacturer

The points presented above under f) also have an impact on the feedback regime to the manufacturer. Since in the first configuration mentioned (client without sustainability preferences is recommended a sustainable product), no target market non-compliance exists, any feedback from the distributor to the issuer should be waived.

We request corresponding clarification on this aspect in the Guidelines (for example, in Guideline 74).

h) Example should be omitted



The new example for target market definition should be omitted, as the target market described in the example is extremely granular. It is our understanding that the description extends far beyond the target market definitions commonly used in the market.

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

The questions raised by ESMA are of great importance in business practice. From our point of view, the following should apply:

- a) How should the target market assessment and the matching of a client vis-à-vis the target market be done if a product does not have ESG characteristics while the client has certain ESG preferences?**

In this configuration, it should be borne in mind that, in view of existing legal uncertainty, manufacturers could continue to restrictively declare their products to be sustainable. It should be made clear that distributors can nevertheless recommend investment products to their clients.

In this respect, it should be stated in the Guidelines that the sale of a product declared not to be sustainable to a client with sustainability preferences is also possible with appropriate justification. This would correspond to the possible two-stage approach proposed for the suitability assessment. This should also be transferred to the target market assessment.

This aspect should be stipulated in addition in the Guidelines themselves and not only in the Final Report. A supplement could be considered here to Guideline 70 of the ESMA Guidelines on Product Governance.

- b) Can ESG considerations be either specified separately from each other or as a single indicator?**

The main issue pertains to the fact that the taxonomy is still being developed and there are currently no legal guidelines on how a manufacturer should evaluate the sustainability of its product when the new product governance requirements will come into force. This distinguishes the new target market criterion from other criteria, such as client category or the risk/reward profile, for which legal provisions exist, on which manufacturers can base the target market definition (client categories under MiFID II or PRIIPs-SRI).

In order to achieve a certain standardisation in the case of the new target market criterion, in spite of the lack of corresponding guidelines, ESMA should provide information on the target market characteristics. Otherwise, it is to be feared that the approach pursued by the Guidelines on Product Governance (see Guideline 16 of the ESMA Guidelines on Product Governance) cannot be achieved in the case of the ESG criteria.

At the same time, it has to be acknowledged that the extensions currently preferred for the suitability assessment and product governance are only a first step. In this respect, a high-level approach should also be preferred for the target market characteristics (at least as a first step). In our view, the target market criterion should be described in the following way until legal requirements are implemented:

- Sustainable: Yes (the product is declared to be sustainable by the manufacturer)
- Sustainable: No (the manufacturer has not declared the product to be sustainable).

Concerning the negative target market we refer to our remarks to Question 7 under d).

In view of the lack of a taxonomy, further characterisations would lead to IT implementations, which within a short time would no longer correspond to the new legal requirements. This would mean that investment firms bear a double burden of very high implementation costs. This would be contrary to the principle of proportionality, which is very strongly emphasised precisely in relation to product governance (see Guideline 11 of the ESMA Guidelines on Product Governance) and should be avoided at all costs.

- c) How should the target market assessment and the matching of a client vis-à-vis the target market be done if ESG considerations of a product are specified separately from each other and a client has differing preferences in all or some of these criteria (e.g. a product shows strong environmental criteria and little governance criteria while the client has little environmental preferences and strong governance preferences)?**

If the target market criterion of sustainability is subdivided into parts (for example into environmental, social and good governance), implementation would be considerably more complex. Client surveys would have to be more granular. The assessment would also be considerably more complex, since the corresponding special characteristics of clients and products have to be reconciled. The problems become clear in the example that ESMA has incorporated in the question.

In view of the still outstanding taxonomy and the associated immense legal uncertainty in product classification, the inclusion of sustainability in the suitability assessment and the product governance should occur (at least as a first step) in general terms. Further subdivisions should occur only when the legal bases exist (i.e., when the Taxonomy Regulation has been finalised).

This gradual approach is also in accordance with the principle of proportionality, which has been explicitly highlighted in both the legal bases (Article 9(1), second subparagraph, and 10(1), first subparagraph, MiFID II Implementing Directive) and in Guideline 11 of the ESMA Guidelines on Product Governance.

- **Question 9 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.**

In view of the fragmented legal framework, the target market definition should only specify whether a product is sustainable or not. Further developments are only possible if there is a corresponding legal framework that clearly defines the individual characteristics.

A more granular determination of sustainability would only increase current legal uncertainty (see above under Q 7).

- **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”? Please describe.**



See answer to Q5. Financial institutions use a wide range of different labels, which provide different scoring due to the lack of a common market standard. This is the reason why the adoption of a taxonomy is key for a more harmonized labels among the industry.

- **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?**

We do not consider that a more detailed approach than the proposed amendment to para 28 of the suitability guidelines to be possible.

ESMA should take into account the cost implications of modifying the suitability evaluation and IT process. ESMA should adopt a proportionate approach to the integration of sustainability risks and sustainability factors in the Guidelines, especially keeping in mind that MiFID II has just been implemented at a high cost and that its review is due shortly.

Moreover, the sustainability assessment of a product could happen to be contradicted in the future by the EU taxonomy. If this was to happen, it would lead to high costs for financial institutions, as they would need to adapt to the new requirements, but also create liability risks in relation to the products which were recommended in the past and would no longer be suitable to the objectives of the client.

ESMA suggests that investments firms should take into account current market standards. However, this is an extremely complicated task because there is still a lack of comprehensive market standards that capture all relevant ESG factors in a suitable way.

- **Question 12 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 value for the ESG preference is appropriate and sufficient. E, S and G criteria are basically equal. However, this does not rule out that investment services firms choose to weight the individual criteria differently.

- **Question 13 Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?**

ESBG agrees with the amendment suggested by ESMA to paragraph 70 of the suitability guidelines. The explicit mention of ESG considerations is made in our understanding only for clarification.

- **Question 14 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

The exact resources to implement the proposed changes are difficult to estimate without more information and time. Such an assessment would only be possible once ESMA has outlined the announced guidance. As examples, here are some costs that would 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;
- Review of product governance processes;
- Review of questionnaire;
- Review of suitability assessment;
- Adaptation of tools that support advisors to recommend a suitable financial instrument;
- Review of suitability statement;
- Clients may want to understand whether their objectives have been achieved;

In addition,

- All investment advisors have to receive new training;
- Time would have to be devoted to explaining ESG information to clients (investors);
- ESG information would have to be requested from all clients asking for advisory or discretionary portfolio management services;

Recurrent costs

- Acquisition of ESG data;
- The advisory process would require more time, especially when the client would have to decide on “trade-offs”.

General speaking, the more detailed ESG considerations have to be incorporated the more complex implementation projects would be, with higher complexity requiring more financial and human resources.

Furthermore, 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 e.g. 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 the obligations that may change very soon.

From the point of view of operational risk, the obligation to develop ESG criteria with little guidance implies substantial liability risks.



About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.



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About WSBI (World Savings and Retail Banking Institute)

WSBI represents the interests of 6,000 savings and retail banks globally, with total assets of \$15 trillion and serving some 1.3 billion customers in nearly 80 countries (as of 2016). WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive, and balanced growth, and job creation, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. Learn more at: www.wsbi-esbg.org



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