European Fund and Asset Management Association

EFAMA response to the ESMA Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD

A. Preliminary comments

The European Fund and Asset Management Association, EFAMA[1], welcomes the opportunity to provide feedback to ESMA's Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD.

EFAMA very much supports the Commission's ambition to encourage and facilitate sustainable investments and be a global leader in sustainable finance policymaking. Many investors already today recognise the importance of sustainability and are selective in their investments in this respect. European asset managers have been integrating ESG in their investment processes in different forms for some time[2] to achieve the diverse sustainability goals of individuals and institutional asset owners. Also and in a more general context, this is part of asset managers' pursuit of helping individuals and institutional asset owners achieve long-term financial returns and a key element of their operational excellence and competitive advantage.

Our members acknowledge that a common language and disclosure building on such common language have the potential to help with the transition to a more sustainable economy. At the same time, it is important that regulatory efforts in this direction don't adopt a prescriptive and narrow approach which would create unintended consequences and stifle innovation in the development of the sustainable investment market in Europe. As regards the ongoing effort to integrate sustainability risks in UCITS Directive and AIFMD, we believe that if any further clarification is necessary this should be done solely at Level 2 and Level 3 given the technical level of the subject and the fact that the relevant provisions of operating conditions, organizational requirements and risk management are under delegated regulation and implementing measures or Level 3 Guidance.

For that reason, we agree with the decision to integrate such risks and factors through delegated acts with no further changes at Level 1, and **we welcome ESMA's high-level-principles-based approach**,

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 14.1 trillion managed by 58,400 investment funds at end 2016. Just over 30,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 27,800 funds composed of AIFs (Alternative Investment Funds). www.efama.org

[2] Screened investments, best-in-class sustainable investment, impact investing, stewardship, thematic investing and ESG integration are examples of a wide range of approaches – cumulative or exclusive – used by asset managers today.

which is similar to the approach already taken for the integration of other risks in the UCITS Directive and AIFMD.

Indeed, given the overall dynamic nature of risk management and governance processes, a principles-based approach allows for the necessary proportionality based on the investment strategy and underlying assets of each investment product. Moreover, ESMA's approach is a positive one as it ensures the level of flexibility that is required in view of the rapid market and regulatory developments in the area of sustainable finance, hence providing the necessary room for further developments and improvements rather than acting as an impediment. Given the different stages of ESG integration in the investment process among different market participants, and the ongoing discussions on policy rules such as the establishment of Taxonomy, adapting a flexible approach means that all actors are equally incentivized in terms of this development and that the risks of a regulatory arbitrage and regulatory errors are mitigated.

EFAMA also considers that **a high-level approach should be consistent among all the current consultation processes concerning the integration of sustainability risks and factors in the investment decision and distribution processes, not the least to make sure that all parts of the investment chain pull in the same direction.** In this context, we would urge ESMA to ensure that a high-level-principles-based approach is also followed within its other consultation process regarding MiFID II, as well as within EIOPA's consultation on the possible changes to the delegated acts under Solvency II and IDD.

A consistent high-level approach requires also a clear understanding of the notion of sustainability risks. From a risk management perspective, "sustainability risk" has to be financially material to the investment. This is the single most important consideration. In other words, "sustainability risk" should mean the financial impact on the investment arising from environmental, social and governance considerations. This has to be clearly distinguished from the process of integrating ESG factors in the investment decision-making process, a concept linked to sustainable investment.

We welcome that this is the notion ESMA is adopting in its consultation paper. We strongly encourage ESMA to maintain this approach in its final technical advice and to ensure the same approach is followed in the other two consultation papers mentioned above[3]. We would also stress that the concept of 'sustainability risk' is to be linked to specific investments and not on an aggregated basis at the level of the portfolio. This point together with the materiality of the sustainability risk are of key importance as the same considerations on sustainability may be material to some investments and not to others, depending on the investment strategy, time horizon, end-investor preference, etc.

[3] EIOPA seems to be taking a similar approach as to the definition of sustainability risks in its consultation paper on changes to Solvency II and IDD. EFAMA submitted its response to EIOPA's consultation, which welcomes EIOPA's clarification that for the purpose of its consultation paper and advice, the choice is to refer predominantly to sustainability risks rather than to sustainable investment, as this is indeed the mandate given by the European Commission to EIOPA. However, we raised some key reservations as to how risks are included in particular provisions of the Solvency II Delegated Regulation (mainly the prudent person principle, question 5), as we consider the proposed provision would be misleading and mixing the notion of sustainable risks with that of sustainable investments, which refers only to a particular subset of investments. See our response to EIOPA's consultation here: https://www.efama.org/Publications/Public/Responsible_Investment/19-4012.pdf#search=sustainability%20risks

Also, in terms of consistency, it is important to provide further clarity as to the terminology used. “ESG” and “sustainability” are being used interchangeably – ESMA’s consultation paper on AIFMD and UCITS Directive makes reference to sustainability risks, whereas the one on MiFID II refers to ESG risks, while there is no clarity regarding the exact definitions of these two terms. For the purpose of this exercise, it is important to adopt the same wording across the three different advices to be provided by ESMA and EIOPA to the Commission. It is also essential that sufficient time be allowed to implement these changes. The Commission is suggesting only twelve months which is far too little time taking into account that changes to the UCITS Directive and AIFMD Level 2 must be implementing into Member States’ national laws first.

Finally, we would like to highlight that the term “factors” added to the notion of “sustainability risks” is confusing. We consider that sustainability factors and considerations are necessarily part of the assessment of sustainability risks as material drivers of the value of a particular investment, and therefore can be important, alongside other factors, in assessing investment risks and opportunities. With this in mind, we understand ESMA’s proposed reference to “sustainability factors” to refer to the aforementioned ESG risks and ESG-related opportunities. Both of these if they are deemed to have financially material impact (negative or positive) on an investment would form part of the assessment of the sustainability risk. For the purposes, therefore, of the changes to UCITS Directive and AIFMD it would be better to keep only the term “sustainability risks”.

B. EFAMA response to the consultation’s questions

Q1: How do you understand or how would you define the notion of “sustainability risks” for the purposes of the delegated acts adopted under the UCITS Directive and AIFMD?

As mentioned in our preliminary comments, it is crucial that “sustainability risks” are understood only as risks to the financial performance of an investment from sustainability considerations and not as externality risks that may be posed from investments to environment and society. From a risk management perspective, “sustainability risk” has to be financially material to the investment. This is the single most important consideration. In other words, “sustainability risks” should mean the financial impact on the investment arising from environmental, social and governance considerations. This has to be clearly distinguished from the process of integrating ESG factors in the investment decision-making process.

It is also important to consider “sustainability risk” in the same way as any other investment risk, such as market or credit risk. Only an integrated approach (for sustainability and other risks) will ensure that any interrelations between non-sustainability and sustainability risks are properly captured. In addition, some factors might comprise both aspects and should therefore be identified, assessed, managed and monitored in an effective, integrated system. In this context, sustainability considerations are to be considered as addition input to the existing risk management processes and not a new stand-alone dimension requiring new and independent processes and resources.

EFAMA can agree with a high-level and principles-based approach to include the notion of sustainability risk in the UCITS Directive and AIFMD level 2 frameworks, as the same approach is followed in the case of other risks (there are already definitions on other risks such as credit risk, liquidity risk, market risk and operational risk). Moreover, as already mentioned we consider that sustainability factors are used for the assessment of different sustainability risks. Therefore, we see no need to make reference to such factors.

Concerning the definition of “sustainability risk” proposed in paragraph 17 of the consultation paper we have the following remarks:

- The notion of sustainability risk is linked to the performance of the fund and as such it is useful and welcome. However, it would be better to clarify that we speak about risks material to the investment and the portfolio.
- As explained in our preliminary remarks, there seems to be a different terminology (“ESG” – “sustainability”) used in an interchangeable manner. A consistent terminology needs to be in place. It is also important that this same term and definition is used for all legal definitions that may come up in other regulatory processes (such as the discussion on the Taxonomy and Disclosures legislative proposals).
- Last but not least, we would like to raise important concerns as to the practical aspects of applying the link between the sustainability factors and the value of the positions, in the absence of relevant data that would enable fund managers to meet this legal requirement. A duty per se would be difficult to implement if in practice there is no data available to make that link.

Our suggestion for the definition of “sustainability risk” would therefore be: “sustainability risk” could be understood as the risk of fluctuation in the value of ***particular investment*** positions in the fund’s portfolio due to ***material sustainability*** factors”.

Q2: Do you agree with the proposed amendments relating to organisational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

All duties with regards to organisational requirements foreseen in UCITS Directive and AIFMD will apply to sustainability risks, the same way they would apply for other risks, e.g. liquidity risk. We therefore believe it should be sufficient to clarify that the responsibility of the management or of specific function like risk management or compliance function regarding risks also comprises sustainability risks. Other than that, we do not see a merit in a further detailed description of organisational requirements regarding sustainability risks.

In this respect, we agree with the proposed amendments aiming at including a reference to sustainability risks with no further prescriptive approach as to their identification or requirements. We also agree with the clarification that fund managers need to employ staff with relevant skills and expertise.

We would like, however, to stress that for reasons explained in our preliminary remarks we see no reason for making a reference also to sustainability factors that are in any case part of the process of assessing sustainability risks.

It is also important that the implementation date of these changes to UCITS and AIFMD level 2 should be aligned with the application of the Disclosures Regulation so as to ensure consistency in the application and avoid confusion for the investors. Such alignment would also allow decreasing implementation costs, which otherwise will be duplicative (if UCITS Directive/AIFMD changes are implemented before the requirements of the Disclosures Regulation, management companies will need to review their processes and procedures once this Regulation is also in place).

Q3: Do you see merit in expressly requiring or elaborating on the designation of a qualified person within the authorised entity responsible for the integration of sustainability risks and factors (e.g. under Article 5 of the Commission Directive 2010/43/EU and Article 22 of the Commission Delegated Regulation (EU) 231/2013)?

EFAMA considers that duties in relation to risks (sustainability risks included) should apply in a consistent way across all types of risk and involve all relevant staff of the UCITS management company and the AIFM, including as ESMA clarifies both the management team and the senior management. Furthermore, involving all relevant staff facilitates full integration of sustainability risk considerations. Therefore, no specific appointment of a person being in charge of the integration of sustainability risk would make sense. Moreover, a differentiated treatment of sustainability risk via the appointment of a designated person may create confusion and give a wrong impression as to different priorities given to different types of risk.

In addition, it is appropriate to leave it to fund managers to further incorporate sustainability risk in their due diligence processes in a way and to the extent that this is appropriate to the size, nature, scope and complexity of their activities and the relevant investment strategies pursued. This is after all in line with ESMA's high-level and principles-based approach for the integration of sustainability risks within the UCITS and AIFMD frameworks.

Q4: Would you propose any other amendments to the provisions on organisational requirements in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

No – please see our response to question 2.

Q5: Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

EFAMA agrees with the high-level-principles-based approach overall and also for the provisions relating to due diligence, but wishes to stress that there are no particular risks with specific sustainability considerations linked to due diligence. Instead we consider that should such situations arise in practice, they should be treated like any other risks and existing rules are sufficient. For that reason, singling out these particular risks seems unnecessary.

Moreover and based on the suggested additions in article 23 para 5 of Commission's Directive 2010/43/EU and article 18 para 5 of Commission's Delegated Regulation 231/2013, management companies and AIFMs respectively are required to take into account sustainability risks and factors in respect to their due diligence requirements. However, sustainability risks are not relevant in the same way for all investments, and investment strategies. For instance, in the case of index-based investments the investment manager has no ability to change portfolio construction above and beyond a particular security's inclusion and weighting in the underlying index. This would lead to unintended tracking error which is not desired by clients.

We would therefore suggest adding the following wording:

"Members states shall require that management companies take into account the ***material*** sustainability risks ~~and factors~~ ***as appropriate to the investment strategy of the portfolio*** when complying with the requirements set out in paragraphs (…)".

Q6: Do you see merit in further elaborating in the provisions above on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments?

As stated in our response to the previous question we consider it important to take into consideration that sustainability risks are not relevant in the same way for all investments and portfolios and therefore they should be taken into consideration as appropriate based on the type of the investment and the overall strategy of the portfolio.

Q7: Do you agree with the proposed inclusion of recitals relating to conflicts of interest? Should the technical advice cover specific examples? If so, what would be specific examples of conflicts of interests that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?

EFAMA understands the idea of integrating potential sustainability risks in recitals, as it fits with the overall high-level-principles-based approach. However, as in the case of due diligence, we wish to stress that we don't see conflicts of interest that are linked in particular with sustainability risks. Instead, we consider that should such situations arise in practice, they should be treated like any other risk and for that existing rules are sufficient. Therefore, singling out these particular risks in the case of conflicts of interest seems unnecessary and we would be in favor of deleting this recital.

Q8: Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

No, we consider that no further amendments are necessary neither they fit with the high-level-principles-based approach taken in this consultation paper.

Q9: Do you agree with the proposed amendments to provisions relating to the risk management included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

The risk management process is one that includes all risks material and inherent to the assets and returns for investors. As such, sustainability risks are already captured, where relevant for the strategy of a particular portfolio. For this reason and due to interrelations between risks, we believe that only an integrated approach for all risks will be efficient and proportionate to deal with sustainability risks.

Sustainability risks should only comprise factors which can have a material impact on the return of the investment. Further, a prescriptive definition of sustainability risks would not be consistent with the overall approach to risk management. The risk management process in each fund needs to be relevant and specifically tailored to its investment strategy, the portfolio's assets and the objectives of the underlying investors. This is the approach already taken at Level 1 and 2 of the AIFM and UCITS Directives. Any changes in the AIFM and UCITS Directives, clarifying how sustainability risks are incorporated in the risk management, should follow this proportionate approach. This would ensure asset managers have the flexibility to assess such risks.

Having this in mind, EFAMA agrees with the high-level-principles-based approach adopted also for the provisions in relation to risk management, in particular as it avoids giving any priority or further specifications concerning sustainability risks and disrupting the balance with other risks. It is important to keep in mind that the assessment on sustainability risk is not a stand-alone function, but one incorporated into the overall risk management function, therefore it needs to be integrated into existing risk assessments as appropriate.

Another key element that needs to be taken into account is the absence of various and solid sources of data in relation the long- term aspects and other sustainability indicators, which make existing data of less reliability and comparability. Given that asset managers are requested to assess the exposures to sustainability risks it would be useful and pragmatic to take into consideration the data constraints investment managers are faced with.

Q10: Do you see merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks (e.g. techniques, tools and arrangements enabling the assessment of sustainability risks, probability of occurrence and time horizon of sustainability risks with regard to the expected time of holding of the positions bearing the risks, quality of underlying data and methodologies etc.)?

No, we don't see the need or appropriateness for any more specific or prescriptive rules for the integration of sustainability risks. Please see also our response to the previous question.

Q11: Do you see merit in amending risk management provisions relating to the regular review of risk management policies and systems in order to more specifically refer to elements related to sustainability risks (e.g. quality of the arrangements, processes, techniques and data used, need for authorised entities to highlight the limitations, and demonstrate the absence of available alternatives)?

No – please see our response to questions 9 and 10.

Q12: Would you propose any other amendment to the provisions on risk management in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risk and factors?

No, EFAMA would propose no other amendments to the provisions on risk management.

Q13: 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.

N/A

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