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INVESTMENT ASSOCIATION RESPONSE TO ESMA CONSULTATION PAPER: ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN THE UCITS DIRECTIVE AND AIFMD

ABOUT THE INVESTMENT ASSOCIATION

- The IA represents 250+ UK-based investment management firms who collectively manage funds totalling EUR 8.1 trillion; of which EUR 2 trillion is on behalf of European clients. The UK asset management industry is a key part of both the UK and EU's financial ecosystem, helping millions of individuals save for the long-term and enabling them to enjoy a more prosperous retirement.
- Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.
- Our purpose is to ensure investment managers are in the best possible position to:
    - Build people's resilience to financial adversity
    - Help people achieve their financial aspirations
    - Enable people to maintain a decent standard of living as they grow older
    - Contribute to economic growth through the efficient allocation of capital.
- The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs (a form of tax-incentivised savings account in the UK).

19 February 2019

1. OVERARCHING COMMENTS

The Role of Asset Managers in Sustainability

As asset managers and significant investors in economies across Europe, it is our role to help investors and savers achieve their objectives – both financial and non-financial.

Whilst responsible investment has existed in various forms for many years, as an industry we are witnessing growing demand for sustainability-related and responsible investment strategies, as investors have become much more aware of the material impact sustainability issues (both environmental and social) could have on financial returns and on broader economic and financial stability. This trend has helped fuel the growth in the responsible investment market and our members are committed to continuing to promote and develop sustainability and responsible investment in all of its forms.

The IA has therefore welcomed the Commission's Sustainable Finance Package with its broad objectives to 1) reorient capital flows towards sustainable investments, 2) manage financial risks stemming from ESG issues; and 3) foster transparency and long-termism in financial and economic activity.

As this is a comprehensive and far-reaching Package, it is vital that the scope of each of the individual Proposals as well as any subsequent components, including this consultation paper, is clarified and that these components work harmoniously with each other to progress this broad agenda.

We ask that European policy makers also consider the global implications of the Package. A lack of coordination, including at a global level, could have unintended consequences which risk putting a brake on existing economic activities that already contribute to a more sustainable economy, as well as on further innovation and growth.

The IA supports European policy makers' commitment to make Europe a global leader in sustainable finance and stands ready to work with ESMA and other key stakeholders to progress this agenda and boost the role of finance in achieving both a well-performing economy and one that also delivers on environmental and social goals.

We thank ESMA for this opportunity to provide feedback on the proposed technical advice to the European Commission on the integration of sustainability risks and factors in the UCITS Directive and AIFMD, in relation to:

- Organisational requirements;
- Operating conditions; and
- Risk management.

We were also grateful for the opportunity to hear from ESMA directly at the public hearing in Paris on 4 February 2019.

Support for a High-Level Principles-Based Approach

We strongly support the decision to take a high level principles-based approach to this task and would like to stress the importance of this.

We also support ESMA's commitment **not to pursue prescriptive measures** to ensure that this relatively young and fast-paced marketplace can continue to grow and innovate.

Investors should be able to continue to access **the full range of sustainability and responsible investment approaches** to meet their many and diverse objectives.

The Importance of Financially Material Sustainability Risks

Action 7 of the Action Plan seeks to clarify that sustainability risks can be material and important considerations in investment and risk management process and that, on this basis, ESG considerations would be consistent with asset managers' existing duties to act in the best interests of their clients.

As such, we are supportive of efforts to bring clarity to where we believe that sustainability risks and factors can be taken into account and, indeed, should be taken into account, where they are deemed to be financially material to a particular investment approach or investment decision.

This clarity should help ensure that sustainability risks are considered proportionately, alongside other relevant, material risks.

More specifically, we welcome ESMA's decision to engage with industry on defining "sustainability risks" and, in particular, the link that has been made between sustainability risks and financial value. Above all, sustainability risks must be linked to financial materiality.

Finally, we look forward to continuing to engage on the Sustainable Finance package and stand ready to offer our assistance however we can.

2. ANSWERS TO SPECIFIC 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?

We are supportive of ESMA explicitly recognising the link between "sustainability risks" and financial value.

Furthermore, we are supportive of ESMA's reference to both sustainability risks and sustainability factors in the proposed amendments, given the scope of the European Commission's formal request of 24 July.

However, given the absence of an explicit definition for "sustainability factors" in the consultation paper, we set out below how we have understood "sustainability risks factors" in the context of ESG integration and would welcome clarification from ESMA on this interpretation.

In its impact assessment of 24 July, the Commission states that investors can invest sustainably by "integrating ESG factors/risks in investment decision making". In practice, the process of integrating ESG factors and risks into investment decision making involves asset managers both continually monitoring and mitigating ESG risks, as well as benefiting from ESG-related opportunities. With this in mind, we understand ESMA's proposed reference to "sustainability risks and factors" to refer to the aforementioned ESG risks and ESG-related opportunities. Both of these would from part of the ESG integration process if they are deemed to have financially material impact (negative or positive) on an investment.

Investors will consider different ESG risks and opportunities to be financially material for different investments. Therefore, there is no definitive list of financially material sustainability risks and factors that would apply to all investments. Instead, the exact nature of these risks and opportunities will differ across investments. For example, data related to an ESG risk like water consumption may be financially material for certain investments and not for others.

Whilst we are supportive of the proposed link between sustainability risks and financial value, we would not advocate referring to the "fluctuation" of the value of positions. Fluctuation would appear to refer to volatility. However, ESG integration does not seek to avoid volatility. Instead, it is about promoting long term performance. If anything, it is about avoiding *loss* in the value of positions (as opposed to their fluctuation).

To reflect the importance of financial materiality, the specificity of ESG-related risks and factors to particular investments, and the link to loss (but not volatility) in value, we would suggest the following definition for "sustainability risks":

Any and all relevant environmental, social and governance considerations that may be deemed to have a negative and financially material impact on the long term sustainability of an investment[1]

By extension we would consider "sustainability risks and factors" to encompass:

Any and all relevant environmental, social and governance considerations that may be deemed to have a financially material impact (positive or negative) on the long term sustainability of an investment[2]

ORGANISATIONAL REQUIREMENTS

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.

We are supportive of taking a high level approach to amendments relating to organisational requirements. This should help ensure that sustainability risks are dealt with proportionately alongside other investment risks, for example, credit risk, liquidity risk etc. We agree that entities should carefully consider whether they have sufficient human and technical resources to assess sustainability risks within their organisation and governance structure. It is important that any amendments are proportionate and allow firms the flexibility to implement these in a way that best fits their business models, investment process and investor base etc.

As ESMA points out, the Commission's objective is to "explicitly require the integration of sustainability risks in the investment decision process". To address this, it should be made clear that any amendments to the organisational requirements at a firm level should be about ensuring firms have adequate *policies* covering the integration of sustainability risks. This should not be confused with the day-to-day processes which integrate sustainability risks and factors into the investment process. In this context, we would like to make clear that senior management should be responsible for the policies on how a firm seeks to integrate sustainability risks and factors into its activities, but not carrying out the integration of sustainability risks and factors in the investment process – which would be done by the investment teams.

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[1] "Investment" might refer to a company, but it could also refer to a number of different things in which you can invest. Examples include real assets (metals, real estate, land etc.) and governments (e.g. United States T-Bills).

[2] As above.

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)?

In line with taking a proportionate approach to the integration of sustainability risks and factors, firms will need to be given the freedom to incorporate sustainability risks into their organisational requirements in a way which is appropriate to their size, nature, scope and complexity.

Individual firms should have the freedom to decide whether they wish to designate a qualified person within the authorised entity responsible for the integration of sustainability risks and factors. This may take the form of a Chief Sustainability Officer, for example. We would expect such a role to be part of the first line function.

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, the proposed amendments achieve ESMA's stated objective of integrating sustainability risks and factors to the provisions on organisational requirements through high level principles. Any further amendments would risk these requirements becoming overly prescriptive and disproportionate.

OPERATING CONDITIONS

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.

We agree with a high-level principles-based approach. We would already expect existing due diligence practices to take account of sustainability risks, where such risks have been deemed financially material to that particular investment strategy or investment decision.

The consultation paper considers "risk limits" in the context of sustainability. If ESMA were to investigate how risk limits might work in practice, we would suggest exercising caution given, in particular, the current challenges around data availability. Risk limits imply factors that must be quantitatively measured and monitored. Data on sustainability risks is currently limited, imperfect and unstandardized, hence consistent and comparable measurement of such risks is often impractical. Risk limits in this context could lead to misleading outcomes, without considerable further work on their practical implementation.

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?

If ESMA were to see merit in elaborating on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments, we would advocate a non-prescriptive, illustrative list of possible sustainability risks and an indication of how these could be monitored.

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?

We agree that firms should manage conflicts of interest as they arise but we would welcome further clarification from ESMA as to what it sees as possible conflicts of interest arising from sustainability risks and factors.

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 would not suggest any further amendments. Any further detail could prove to diverge from the high level principles-based approach which ESMA has set out to achieve and could become prescriptive.

RISK MANAGEMENT

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.

Sustainability risks should be considered where they are deemed financially material to a particular investment strategy or investment decision. As such, we would expect them to be taken into account without further explicit clarification. Having said that, we are supportive of any approach which considers them alongside other relevant risks, which we understand to be the intention of the proposed amendments.

However, as above, we have concerns around the availability and effectiveness of the data that is currently available. We expect the quality and availability of data will improve in time but, meanwhile, regulatory interventions have to reflect the present circumstances and it is important that any draft technical advice does not make firms reliant on the services of unregulated data providers.

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.)?

If ESMA should decide to specify further content, this should be for illustrative purposes only to allow firms the flexibility to develop policies that fit their business model, investment process and investors base.

Q11: Do you see merit in amending risk management provisions relating to 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)?

If ESMA should decide to amend risk management provisions in this way, this should be for illustrative purposes only to allow firms the flexibility to develop policies that fit their business model, investment process and investors base.

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 – we are supportive of a high level approach and the flexibility for firms to make these judgements based on their investment strategies.

COST-BENEFIT-ANALYSIS

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.

This will vary between firms dependent on how advanced the integration of sustainability risks and factors is, as well as on the nature, size and business model of their institution and on their investment processes.