Frankfurt am Main,
19 February 2019

BVI's response to the ESMA consultation paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD (ESMA34-45-569)

Encouraging investments in sustainable products is a core element of the broader move towards a more sustainable environment. ESG factors play an increasingly important role in investment decisions. A growing number of institutional investors and asset managers already use methods of selecting investments taking material ESG considerations into account throughout their portfolios.

BVI[1] is therefore supportive and welcomes the pending EU measures on sustainable finance, including integration of sustainability risks in the organisational requirements and operating conditions for UCITS and AIF managers. **In particular, we strongly agree with the high-level, principle-based approach proposed by ESMA.** In an ideal world, a common understanding on sustainability would have been developed beforehand. However, given the parallel running initiatives and the rapid market developments regarding sustainable finance, it is of utmost importance that the regulatory requirements remain flexible enough in order to facilitate these developments. We are convinced that principle-based rules are the right approach at the current stage of the ongoing process for the following reasons:

- As regards ESG integration in the investment process, some market participants are more advanced than others. Principle-based rules will allow market participants to move forward from their different starting points while avoiding burdensome and extensive implementation.

- Principle-based rules are likely to be compatible with future developments such as the establishment of the Taxonomy and extension of the EU Ecolabel. Detailed requirements, if established at this stage, will most probably deviate from future standards. Double implementation would confuse investors and be detrimental to a positive approach towards sustainability. Rather than requiring investors and market participants to implement detailed requirements which would possibly have to be adjusted due to future developments, ESMA's principle based approach allows to use and refine the existing approaches.

- Principle-based rules are in line with the regulatory approach already followed for other relevant risks under UCITS and AIFM Directives. A more detailed regulation always gives the impression that this aspect is more important than others. If, for instance, the requirements for identification and monitoring of sustainability risk were described in more detail than for other risk elements, they would likely be considered more relevant.

As a more general observation, we see deviations in the wording of ESMA's consultation paper regarding changes to AIFMD and UCITS Directive and the consultation paper regarding amendments

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's more than 100 members manage assets of some 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22% in the EU Germany represents the largest fund market as well as the second fastest growing market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

BVI
Bundesverband Investment und Asset Management e.V.
Contact
Phone +49 69 15 40 90 0
www.bvi.de
BVI Berlin
Unter den Linden 42
10117 Berlin
BVI Brussels
Rue du Trône 14–16
1000 Bruxelles
BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main
Executive Board
Thomas Richter CEO
Rudolf Siebel MD

to MiFID II. While the former uses the terms “sustainability risks and factors”, the latter uses “ESG considerations” and “environmental, social and governance factors”. We suggest aligning the wording, where possible.

Against this backdrop, we would like to answer the questions for consultation as follows:

***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 agree with the understanding of suitability risk as suggested by ESMA in para. 17. In view of the fiduciary role of asset managers as agents of their investors’ interests, it is entirely consistent to focus sustainability risk in this context on fluctuations in the value of positions in a fund’s portfolio. However, fluctuations of the market value as such should not be seen as a risk, but only as a measure to assess the risk of loss to the fund portfolio. Under this approach, sustainability risk should conceptually classify as a specific sub-set of market risk. To put it differently: sustainability risk is market risk inherent in a portfolio due to sustainability factors.

Moreover, we would see merit in such understanding being enshrined in the fund rules. In particular, the UCITS Level 2 Directive 2010/43/EU already provides for definitions of other material risk elements such as counterparty risk, liquidity risk, market and operational risk.[2] It appears only consequent to complement this list by a definition of sustainability risk in line with the approach proposed in the consultation paper. The specific wording should ensure that the interlinkage with the market risk concept is evident. Therefore, we suggest including an amendment to Article 3 of the Commission Directive 2010/43/EU which should read as follows:

> *10 (new). “sustainability risk”: the risk of **loss for the UCITS resulting from** fluctuation in the value of positions in the fund’s portfolio **attributable to** sustainability factors.*

Furthermore, it is important to warrant consistency of language with the requirements applicable to other relevant risks. ESG or sustainability factors need to be determined in the internal risk management process, as proposed by ESMA, in order to assess and monitor the materiality of sustainability risk. In other words, identification and monitoring of relevant ESG factors is indispensable for the purpose of proper risk management. However, the integration requirements for organisational purposes should be focused on the sustainability risk itself without further reference to sustainability factors. In making a specific reference to sustainability factors, ESMA would single out these factors compared to other factors that are relevant for other risks (e.g. liquidity factors for liquidity risks). A specific requirement to integrate sustainability factors e.g. as regards internal organisation and resources will jeopardise the balanced approach and might create legal uncertainties potentially resulting in multiple layers of consideration without generating any added value.

Therefore, we recommend deleting references to sustainability factors from the draft technical advice and to provide for explanation of the interdependencies between suitability risk, suitability factors and indicators in the ESMA’s accompanying analysis. Such explanation is already included in section 3 of the consultation paper (para. 27).

---

[2] Cf. Article 3 No. 7 to 10 of the Commission Directive 2010/43/EU of 1 July 2010.

***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 strongly agree with the high-level, principle-based approach proposed by ESMA. In our view, this concept will allow for appropriate consideration of sustainability risks and factors without further interfering with the organisational arrangements already established by authorised managers of UCITS and AIFs. It is also in line with the regulatory approach followed for other relevant risks under both fund frameworks. Moreover, given the current regulatory dynamics in the area of sustainable finance, a principle-based approach appears best-placed to accommodate potential implications of pending legislative procedures at EU level.

As explained above, however, we would like to suggest focusing the proposed amendments on “integration of sustainability risks” and to delete the reference to sustainability factors for the purpose of organisational requirements. ESG or sustainability factors need to be determined in the internal risk management process, as proposed by ESMA, in order to assess and monitor the materiality of sustainability risk. In other words, identification and monitoring of relevant ESG factors is indispensable for the purpose of proper risk management. However, the integration requirements for organisational purposes should be focused on the sustainability risk itself without further reference to sustainability factors. A specific requirement to integrate sustainability factors as regards internal organisation and resources will jeopardise the balanced approach and might create legal uncertainties potentially resulting in multiple layers of consideration without generating any added value.

***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)?*

We do not see further need for, or merit in, requiring the designation of a qualified person who shall be responsible for integration of suitability risks within a management company. A clear advantage of the high-level, principle-based approach as proposed by ESMA is that it accounts for the element of proportionality in integration of sustainability risk, allowing for accommodation to fund management activities of different size and with different investment focus. The requirement for the necessary resources and expertise as envisaged in Article 5(5) of the Commission Directive 2010/43/EU and Article 22(3) of the Commission Delegated Regulation (EU) 231/2013 should be sufficient for ensuring effective integration of sustainability risk. In addition, a specific requirement to have a designated person for sustainability risk would potentially attach too much weight to this type of risk as compared with other material portfolio risks for which no such requirements exist. It is important to avoid the impression that sustainability risk is of particular relevance for the fund managers’ operations.

***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. As stated before, we strongly believe that more detailed requirements would not be in line with the principle-based approach which is the right way forward at this stage.

***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.*

As stated above, we entirely agree with the high-level, principle-based approach proposed by ESMA. In our view, this concept will allow for appropriate consideration of sustainability risks and factors without further interfering with the organisational arrangements already established by authorised managers of UCITS and AIFs. It is also in line with the regulatory approach followed for other relevant risks under both fund frameworks. Moreover, given the current regulatory dynamics in the area of sustainable finance, a principle-based approach appears best-placed to accommodate potential implications of pending legislative procedures at EU level.

In more specific terms, we think that the level of due diligence to be required for integration of sustainability risk should be consistent with the general due diligence process. While the proposed amendments to the Level 2 provisions seem to be in line with this assumption, the accompanying analysis may suggest otherwise. In particular, in para. 28 it is stated that an investment analysis in terms of sustainability risk should be performed "where sustainability risks have a material impact on the financial return of investments". In order to remain consistent with the investment analysis approach adopted by fund managers for other risk elements, it would be helpful to clarify that such material impact should be assessed on the basis of a portfolio approach, i.e. taking into account the relevance of sustainability risk associated with specific investments for the overall fund portfolio. On this basis, it might be acceptable to take higher sustainability risk on investments representing only a small proportion of the overall portfolio as compared to positions with a higher portfolio share. Furthermore, the example in para. 27 regarding the employee's security will be relevant for some investments but not for others. The sustainability standards accounting board shows in its materiality map that, depending on the industry, some aspects are more relevant than others[3].

***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 explained in our reply to Q5 above, we would see merit in clarifying that investment analyses in terms of sustainability risk should be performed with a focus on the contribution of a specific investment/position to the overall portfolio. Otherwise we do not see the need for further specifications of the relevant provisions since we believe that the level of due diligence and subsequent monitoring for sustainability factors should be the same as for any other factors which might lead to material risks.

***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?*

In our view, the requirements for integration of sustainability risk should be consistent with the requirements pertaining to other types of risk. Sustainability risk should not be specifically stressed in order to avoid the impression that it is of particular relevance for the fund managers' operations. Therefore, we do not see the need for a specific recital on identification of potential conflicts of interest

[3] see materiality.sasb.org

with regard to integration of sustainability risk. Since such integration will become a mandatory element of the internal organisation of, and business operations by, fund managers, the relevant provisions of Article 18(2)(a) of the Commissions Directive 2010/43/EU and Article 31(2)(a) of Delegated Regulation (EU) 231/2013 on conflict of interest management will become applicable anyway.

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. As stated before, we strongly believe that more detailed requirements would not be in line with the principle-based approach which is the right way forward at this stage.

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.*

As elaborated in our general comments above, we entirely agree with the high-level, principle-based approach proposed by ESMA. Specifically with regard to risk management policy, sustainability risk should be considered alongside other types of risk potentially relevant to the managed fund portfolios.

This being said, it is important to understand that the concept of sustainability risk proposed by ESMA is not a new stand-alone risk element, but rather a specific sub-set of market risk. To put it differently: sustainability risk is market risk inherent in a portfolio due to sustainability factors. Therefore, as it stands, sustainability risk in funds is in general not identified and measured separately from other risks. Rather, it is included into the exposure to other relevant risks or considered part of the price valuation of portfolio assets.

> *Illustrative example: A UCITS invests in shares of an oil company which shows no interest to engage in the development of alternative fuels. This is relevant in terms of sustainability risk, but also impacts the market value of the company's shares, thus potentially resulting in a market risk for sustainability reasons.*

As regards the proposed amendments, ESMA should bear in mind that approaches in the market for the measurement of sustainability risk are not fully standardised and the quality of available data still needs improvement in particular with respect to comparability and reliability. Furthermore, data on long-term aspects is still scarce. Identification of a specific exposure of a fund portfolio to sustainability risk will thus be a challenging exercise.

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.)?*
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)?*

In our view, the requirements for integration of sustainability risk should be consistent with the requirements pertaining to other types of risk. Sustainability risk should not be specifically stressed neither subject to more detailed rules in order to avoid the impression that it is of particular relevance for the fund managers' operations as compared to other risks. Therefore, we see no merit in providing further regulatory specifications for the content or regular reviews of the risk management policies with a particular focus on sustainability risk. A major advantage of the high-level, principle-based approach proposed by ESMA is that it enables fund managers to integrate sustainability risk by using the existing arrangements and processes while taking into account their individual level of progress in the ESG area. A more detailed regulation would inhibit such development.

Moreover, as explained above, the approaches in the market for the identification and measurement of sustainability risk are not yet standardised. Nonetheless, the ESG investment sector is evolving in a dynamic way, with new risk measurement methods being developed. Fund rules must not be too prescriptive in order to enable fund managers to take avail of such innovation and to offer state-of-the-art competitive investment solutions for investors.

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. As stated before, we strongly believe that more detailed requirements would not be in line with the principle-based approach which is the right way forward at this stage.

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, organizational 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 below cost estimation is an example provided by one German fund manager:

Information requested	**Firm response**
Firm size (annual turnover in euro)	
Number of employees	
Firm complexity (low/medium/high)	high
Expected costs from market research related to ESG factors (in euro)	
Expected IT costs related to ESG factors (in euro)	Initial: EUR 200,000
	On-going: EUR 150,000 p.a.

<table>
<tr><td rowspan="2">Expected training costs related to ESG factors (in euro)</td><td>Initial:</td></tr>
<tr><td>On-going:</td></tr>
<tr><td rowspan="2">Other expected organisational costs related to ESG factors (in euro) – please describe</td><td>Initial:
EUR 300,000</td></tr>
<tr><td>On-going:</td></tr>
</table>