Response to consultation

Consultation on the amendments to the Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage € 8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Overarching Comment

As investment managers, we seek to deliver on our clients' investment goals, including the generation of long-term sustainable returns and, where appropriate to the investor, allocation of capital to investment strategies with environmental or social characteristics or in the pursuit of certain sustainability objectives. We are committed to the growth and development of sustainable finance and support European policymakers' demonstration of global leadership. Specifically, we welcome the 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.

We thank the Commission for this opportunity to provide feedback on the draft amendments to the Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

The integration of sustainability risks, factors and preferences into organisational requirements and operating conditions for investment firms is a key step towards ensuring:

- Firms take account of material sustainability risks across their processes
- The sustainability preferences of investors are considered across the distribution chain.

Nevertheless, we have some concerns around aspects of the drafting, specifically whether it will achieve the Commission's objectives. We set these out in more detail below – alongside proposed amendments – in an attempt to help achieve the goals of the Action Plan in practice.

Summary of Key Points

1. **Suitability Assessment and the definition of "Sustainability preferences."**

- We welcome clarification of the hierarchy of assessment criteria and grandfathering
- We have serious concerns about the definition of "sustainability preferences". The proposed definition narrows the universe of sustainability-related products beyond the categories set out in Regulation (EU) 2019/2088. It also reduces the scope of investment approaches and products which could be offered to investors in line with their needs and goals.

2. **Integrating sustainability risks and factors**

- We have concerns around data availability and the need to recognise the importance of qualitative assessment
- Sustainability risks should be considered alongside other risks

Detailed comments and drafting suggestions

1. **Suitability Assessment and the definition of "Sustainability preferences."**

Suitability assessment

We welcome the clarification with regard to the hierarchy to assess product suitability, that is, the assessment of investor's investment objectives, time horizon and individual circumstances, before asking clients for their potential sustainability preferences.
We support this approach as sustainability preferences should not take precedence over a client's investment objectives in order to avoid mis-selling.
We agree with this two-step process, which importantly addresses the potential conflict between a client's sustainability preference and conventional investment objectives by saying that the latter has priority. It also fits within existing KYC/profiling processes as firms are able to satisfy a client's sustainability preferences in addition to the existing mandate.
As highlighted in the preliminary comments to the delegated act draft, this is necessary to avoid potential misselling.

We also support the inclusion of provisions which clarify that for existing contracts, for whom a suitability assessment has already been undertaken, investment firms should be able to rely on the existing suitability assessment. This will undoubtedly facilitate the development of fit-for-purpose processes within firms. However, within the text, this provision does not seem to be reflected.

"Sustainability preferences" definition

We welcome the efforts to bring about alignment across regulations by introducing a definition of "sustainability preferences" that references the Regulation (EU) 2019/2088.

However, flexibility in the market must be retained to draw on any one of a number of different sustainable and responsible investment approaches, which cater to investors' multiple and varied investment objectives.

The draft proposals limit the remit of sustainability preferences to financial instruments that have as their objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 and to financial instruments that promote environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 provided that these either pursue specific sustainable investments or consider adverse impacts at fund level.

a. <u>Misalignment with other regulations</u>

The Regulation (EU) 2019/2088 distinguishes between products promoting environmental and social characteristics (i.e. Article 8 products) and those pursuing sustainability objectives (i.e. Article 9 products). Restricting the scope of Article 8 products which could be made available as per the new sustainability preferences definition can potentially create greater confusion among investors.
The Regulation (EU) 2019/2088 allows for Article 8 products which do not follow the added conditions prescribed by the definition of sustainability preferences to be classified as products promoting environmental and social characteristics.
In fact, many ESG products would fall into the Article 8 category as a "light green" ESG product but then unless they meet these additional constraints, would not be deemed to be suitable for clients with sustainability preferences.
Excluding these products from the offering might create confusion for investors and be challenging when complying with MiFID Article 24(3) "*All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading".*
The type of products which can be considered as sustainable must be consistent throughout all relevant pieces of EU law.

b. <u>Restricted view of investors potential needs and goals</u>

The definition as it stands excludes products that promote environmental or social characteristics without the added layer of sustainable investment or consideration of adverse impact and limits the primary offering without considering the broader scope of investors' possible investment objectives when it comes to products which promote environmental or social characteristics. This narrowing of the universe of funds could result in investors not being matched with funds that suit their needs and goals.

c. <u>Effect on investment universe</u>

Narrowing the universe of funds in this way specifically precludes offering products that may be contributing to sustainability through facilitating transition, but which would not necessarily be captured by "sustainability preferences" under these amendments. The new rules need to afford room for investors to choose approaches that use stewardship to engage and improve businesses that may not yet be deemed environmentally sustainable. This risks channelling capital into assets that are already sustainable and not necessarily helping to decarbonise the economy as a whole.

Proposed changes to Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

We suggest deleting the added provisions in Recital 6:

(6) Sustainable products with various degrees of ambition have been developed so far. To enable clients to better understand those products, investment firms that provide investment advice and portfolio management services should clearly explain the distinction between financial products that promote environmental or social characteristics and financial products that pursue sustainable investment objectives. *~~Whilst financial products that pursue sustainable investment objectives guarantee the attainment of certain level of sustainability, financial products that promote environmental or social characteristics do not necessarily achieve that. That is why the identification of the client's sustainability preferences should in case of financial products that promote environmental or social characteristics take into account those financial products that at least to some extent pursue sustainable investment objectives, or consider principal adverse impacts on sustainability factors, as laid down by Regulation (EU) 2019/2088. Since, in accordance with that Regulation, certain manufacturers of financial products should be obliged to provide information on how their financial products consider principal adverse impacts on sustainability factors at the latest as of 30 December 2022, investment firms should be able to increasingly recommend also those products as suitable in terms of clients' sustainability preferences after that day.~~*

We suggest amending the sustainability preferences definition in Article 1 (7)

"(7) 'sustainability preferences' means a client's or potential client's choice as to whether either of the following financial instruments should be integrated into his or her investment strategy:
(a) a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;*
(b) a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088;
~~and that either:~~
~~(i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or~~
~~(ii) as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in Article 7(1), point (a), of that Regulation; or~~

2. Integrating sustainability risks and sustainability factors

Integration timing

As mentioned above the IA supports European policymakers' commitment to make Europe a global leader in sustainable finance and recognise the need to implement adequate practice through regulations as soon as possible
However, we would like to highlight that adding sustainability risks and factors to existing processes may be complicated as this stage. The regulator should be mindful that some orchestration between advice firms and asset managers is needed. Furthermore, data sets are improving but far from universally accepted. Investment firms will need to consider how usable data and proxies can be used to include sustainability factors and how these can be made available to firms in a cost-effective way.

Disproportionate emphasis on sustainability risks

We support the integration of sustainability risks alongside all relevant financial risks on an ongoing basis and as part of the conflicts of interest identification process.
Clearer definitions allow more informed decisions making for greater accountability for addressing sustainability risk, and it is necessary to ensure that these are embedded in processes, systems and internal controls of investment firms, and that technical capacity and knowledge is put in place to analyse those risks.

We are nonetheless concerned that the amendments require firms to consider sustainability risks disproportionately in comparison to other relevant, material investment risks such as credit risk, liquidity risk etc.
As sustainability risks need to be considered equally alongside other risks, we would suggest potentially adding more prominent details in the Recitals.

Proposed changes to Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

We suggest deleting the added provisions in article 21 and 23:

~~*(2) in Article 21, paragraph 1 is amended as follows:*~~
~~*(a) the second subparagraph is replaced by the following:*~~
~~*"Investment firms shall take into account sustainability risks when complying with the requirements set out in this paragraph.";*~~
~~*(b) the following subparagraph is added:*~~
~~*"When complying with the requirements set out in this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.";*~~

~~(3) in Article 23(1), point (a) is replaced by the following:~~
~~"(a) 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. In doing so, investment firms shall take into account sustainability risks;";~~

And amending Recital 3, as shown below:

(3) In March 2018, the Commission published its Action Plan 'Financing Sustainable Growth', setting up an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in the Action Plan is to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth. The impact assessment underpinning subsequent legislative initiatives published in May 2018 demonstrated the need to clarify that sustainability factors should be taken into account by investment firms as part of their duties towards clients. Investment firms should therefore consider not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks as referred to in Regulation (EU) 2019/2088 of the European Parliament and of the Council that, where they occur, could cause an actual or potential material negative impact on the value of an investment. *~~Commission Delegated Regulation (EU) 2017/565 does not explicitly refer to sustainability risks. For that reason and~~* **Investment firms should, therefore, ensure that along with other risks, sustainability risks are considered as part of their internal procedures and organisational arrangements.**

Data challenges and the importance of qualitative assessment

As stated in the Regulation (EU) 2019/2088 Recital 15:
*"This Regulation seeks to achieve more transparency regarding how financial market participants and financial advisers integrate sustainability risks into their investment decisions and investment or insurance advice. Where the sustainability risk assessment leads to the conclusion that there are no sustainability risks deemed to be relevant to the financial product, the reasons therefor should be explained. Where the assessment leads to the conclusion that those risks are relevant**, the extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms."***

We strongly support the approach whereby Firms should have the flexibility to conduct the risk assessment in quantitative and qualitative terms, as appropriate. It is particularly relevant in cases where appropriate and reliable data is limited and can only increase transparency through the overall process.

Furthermore, this approach echoes the European Central Bank draft guide on climate-related and environmental risks published in May 2020, where qualitative assessment is recognised as an intermediate step: "*The ECB expects institutions to assign quantitative metrics to climate-related and environmental risks, particularly for physical and transition risks. However, it also acknowledges that common definitions and taxonomies in these risk areas are still under development, and that **qualitative statements can be used as intermediate steps while the institution is developing appropriate quantitative metrics**.*"

We would, therefore, welcome an added provision within the delegated regulation text to acknowledge the ability for firms to assess upfront and during the whole risk management process, the sustainability risks either in qualitative or quantitative terms, in particular when appropriate and reliable data is not available.

We would like to thank the Commission again for this opportunity to provide feedback on the draft amendments and hope our comments will positively contribute to the effort to include sustainability risks and preferences within existing Regulations.