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

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Introduction

Invesco welcomes the opportunity to provide its feedback on the consultation by ESMA on integrating sustainability risks and factors in the UCITS Directive and AIFMD. Invesco is an independent investment management firm dedicated to delivering an investment experience that helps people get more out of life. We are privileged to manage more than $930 billion in assets on behalf of clients worldwide (as of January 31, 2019). We have specialized investment teams managing investments across a comprehensive range of asset classes, investment styles and geographies and employee over 7,000 employees focused on client needs across the globe, with an on-the-ground presence in 25 countries.

Invesco is committed to adopting and implementing responsible investment principles in a manner that is consistent with our fiduciary responsibilities to our clients. As fiduciaries, our priority is to protect our clients’ interests, while seeking to deliver strong, long-term investment performance. Invesco is a signatory to the UN Principles of Responsible Investment (“UN PRI”) and recognizes the importance of ESG issues as part of a robust investment process. Invesco was awarded an A+ rating in 2017 and 2018 for Strategy and Governance by the UN PRI.

We welcome the high-level and principles-based approach proposed by ESMA as we believe that this is key to preserve the diversity of approaches in the marketplace reflecting the diversity of investment strategies available. UCITS, and in particular AIFs, invest in a broad range of assets that is not limited to securities issued by companies (equity and corporate debt) but includes sovereign debt, currencies, real assets and derivatives. Approaches to the integration of sustainability risks are, therefore, asset-class and investment-style dependent and should be built in to the investment philosophy of the fund, rather than an overlay applied from a top-down perspective.

In order to illustrate this point, the first part of our response provides an overview of our current approach to integrating ESG in our investment process across the variety of investment styles and asset classes in which we invest to illustrate the breadth of approaches currently used and some of the challenges encountered. Our approach to ESG integration considers ESG factors in a broader sense and therefore goes beyond sustainability risks, which are the focus of the ESMA consultation, but we offer this as context to the responses that follow and informs the way we would look to implement these requirements. The second part provides responses to the questions posed in the consultation paper.
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Part 1: Invesco’s approach to ESG integration

Invesco believes that incorporating environmental, social and governance matters into an investment process is and should always be about investing. At the outset, we believe that it is necessary to make a clear distinction between integrated ESG investment strategies and sustainable investment strategies. We believe that the key differentiator between the two is about how the investment strategy is defined.

- An integrated ESG investment strategy has financial performance as its sole objective; the consideration of ESG factors alongside financial information in the investment process serves to take a more holistic view of the investment and its long-term financial performance. An integrated ESG investment strategy is not an overlay and does not necessarily lead to the restriction of the investment universe according to ESG criteria, i.e. ESG integration does not require overweighting the best performing companies on ESG criteria.

- A sustainable investment strategy, however, has an explicit ESG investment objective, i.e. it is targeting investment in companies or assets that will deliver a positive financial performance as well as social and/or environmental performance. Such strategies usually take the form of overlays and will focus the investment universe, for example through excluding certain sectors or selecting sectors, companies or projects with positive ESG performance on an absolute or relative basis.

This distinction is important as any regulatory framework relating to the integration of sustainability risks must not blur the line between these two approaches. We believe that ESG integration is a core part of our fiduciary duty to our clients but that the choice to pursue a sustainable investment strategy must be an active choice by the client. Furthermore, the investment approach, tools and level of oversight applied with regards to ESG issues will be proportionate depending whether it is an ESG integrated fund or a sustainable investment fund.

We believe that a high-level principles-based approach is important to reflect the diverse approaches adopted by investment managers. This diversity is reflected within Invesco, which means that our investment centres and investment strategies will vary their approaches to ESG integration based on their strategy and investment style. Global resources, both in terms of external research input and a global team of experts, underpin and drive this effort alongside our investment centres.

Underpinning all of our diverse approaches to ESG integration is a strong emphasis on governance and engagement. One of the most important foundations of Invesco’s ESG efforts is a highly flexible proprietary voting platform that enables the company’s fund managers to take well-informed, thoughtful and independent proxy investment decisions. Invesco has an investor-led, investor driven approach to proxy voting. We believe that aligning the investment decision with the proxy voting decision results in robust voting outcomes for our clients.

To illustrate this diversity of approaches, we provide examples of our approach to ESG integration across our platform:

Invesco Henley Investment Centre

The Henley Investment centre manages assets of nearly 120bn EUR across equities, fixed income and multi-asset. As long-term, valuation-led, active investors, the Henley investment centre process is aligned with ESG integration and active ownership, recognising the differences between asset classes and geographies. The Henley investment centre ESG principles will be applied in a variety of ways, depending on the asset class and strategy. ESG issues are considered as one input to the investment process, as part of the evaluation of ideas, company dialogue and portfolio monitoring. As such, evaluation of ESG aspects is incorporated into the wider investment process as part of a holistic consideration of the investment risk and opportunity. ESG issues will therefore be considered alongside other economic drivers when evaluating the attractiveness of an investment. The fund managers have absolute discretion in taking a view on any given ESG risk or opportunity.
The core aspects of the investment philosophy of the Henley investment centre include: materiality, ESG momentum and engagement. Materiality refers to consideration of ESG issues on a risk-adjusted basis and in an economic context. The concept of ESG momentum, i.e. improving or decreasing ESG performance over time, is particularly interesting as we find that companies that are improving in terms of their ESG practices may enjoy superior financial performance in the longer term. Dialogue with investment companies is a core part of the investment process, including board-level dialogue to provide shareholder views on management, corporate strategy, transparency and capital allocation, as well as wider ESG aspects.

In defining the Henley investment centre’s ESG philosophy, 9 core ESG issues are considered, based on a range of ESG frameworks and guidance, including the Paris Climate Accord, the Integrated Reporting Framework, Sustainable Accounting Standards Board and the 10 Principles defined by the UN Global Compact:

The Henley investment process is based on the consideration of ESG issues on a security-by-security basis, based on data from external ESG rating providers, the investment professionals and investee engagement. The Henley investment centre believes that working on the basis of engagement or dialogue, rather than exclusion/divestment, is better aligned with both superior investment performance and improving ESG performance. The Henley investment centre incorporates ESG portfolio monitoring, including a rigorous semi-annual process with fund managers and analysts to go through the portfolio from an ESG perspective.
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Invesco Fixed Income

Invesco Fixed Income (IFI) manages over 250bn EUR in assets with core capabilities in multi-sector fixed income, investment grade debt, global liquidity, senior secured loans, structured securities (comprising RMBS, CMBS and ABS), stable value, US municipals, emerging markets and high yield. IFI follows an independent, fundamentals-based research approach that is deeply resourced by a 169-strong investment team.

IFI believes that evaluating ESG criteria leads to better long-term risk adjusted returns. Its approach, therefore, integrates ESG evaluations into the fundamental research carried out by its credit research analysts.

IFI has structured its ESG research process to operate within the core fundamental research approach. In fundamental credit research, credit analysts rate issuers on their creditworthiness and assess their credit trend. IFI applies the same principles to ESG analysis; its objective is to provide a clear indication of each issuer’s current status (a proprietary ESG score) and a forward-looking trend assessment of how its ESG risk factors may develop (please see the diagram below).

ESG analysis is structured around delivering median-based assessments across three perspectives. First, IFI analysts consider each issuer’s performance versus its sector peers across core and sector-specific measures under the three pillars of Environment, Social and Governance. How highly an issuer scores on each ESG Factor depends on these assessments but importantly, each analyst’s judgment on whether it is demonstrating an improving or deteriorating trend on these measures overall.

Second, the ESG factor scores are mapped to an overall ESG Score represented by a five level grading scale. Issuers demonstrating all factor scores as above median and on an improving trend are rated A. Transparency about ESG momentum is further enhanced by an overall trend indication.

The key elements of IFI’s ESG integration framework are data collection, analysis, and engagement. IFI has built a strong data collection process incorporating data from external ESG rating providers, which provides visibility into issuer level historical ESG trends. They have established a proprietary ESG rating process after years of performing ESG risk analysis. ESG risk assessments ma lead to deciding factors in capital allocation when similar opportunities exist in credit markets.

IFI believes that integrating ESG criteria into research can benefit clients by providing them with an independent assessment of each investment’s suitability for responsible investment strategies to complement ratings from third party providers or indeed, expand the investable universe for issuers not yet covered by external providers. In addition, IFI’s global standards for research and investment
decision-making allow for ESG considerations to be applied across asset classes thereby enhancing comparability for multi-sector fixed income portfolios.

**Invesco Quantitative Strategies**

Invesco Quantitative Strategies ("IQS") offer factor-based investment strategies and currently has nearly 200bn EUR of assets under management in equities and fixed income. IQS takes a holistic approach to integration ESG in line with their systematic, quantitative approach:

ESG considerations are considered as part of the factors applied to the portfolio. In particular, governance is considered as part of the “Quality” factor as the Quality signals prefer companies with less aggressive accounting, that are not “empire-builders and that are not financial constrained.

IQS views ESG as a potential driver of risk and therefore ESG is considered with the aim of limiting downside risk in the portfolio. The IQS strategy integrates ESG through the consideration of adverse ESG momentum and an ESG exposure control. Companies that experience severe downgrades, causing markets to reassess the companies’ core processes and values, are found to continue to underperform after the downgrade event, and based on the much higher importance attached to ESG today, IQS expect this to have a greater impact going forward. IQS therefore excludes any stock subject to a severe downgrade for a least 6 months from strategies that are not manage to a tight tracking error. For highly-benchmark aware strategies, IQS will limit to relative exposure to a quarter of the allowed maximum position in a strategy. In addition, the overall portfolio is subject to an ESG exposure control, which limits exposure to ESG risks.

For clients seeking a sustainable investment strategy, IQS also offer customers customized ESG portfolios, based on best-in-class and negative/positive screening based on customised ESG criteria.

IQS also conducts engagement and proxy voting. IQS enters into regular dialogue with companies via the Global Engagement Service of VigeoEiris. The objective is to identify weaknesses in the company’s sustainability management and discusses these with management to enable the companies
Invesco Real Estate

Invesco Real Estate managed global investment in direct real estate, such as hotels, shopping centres and offices, as well as real estate securities.

IRE recognises that there are ESG implications to all the investment decisions made as an investment manager. Therefore, in assessing risks and opportunities regarding ESG, IRE remains focused on the financial implications of our decisions as well as the social and environmental impact. IRE adopts a well-thought through and disciplined approach to ESG, where ESG is integrated into all phases of the investment manager process.

IRE has defined a number of ESG objectives across global strategies, with a focus on:

**Environmental:**
- Measuring and regularly reporting on building energy, emissions, water and waste within our control, in doing so, seeking to continually and steadily improve across our managed portfolio. Targets are established at a property level and reviewed no less than annually. Our long-term reduction target is 10% or approximately 1% per year in energy, emissions, water and waste.
- Evaluating and implementing low-cost measures, capital improvements and new technologies to improve the performance of our assets and advance the built environment.
- Using Energy Rating schemes to evaluate the energy efficiency of buildings and pursuing certification of eligible buildings annually and evaluating the feasibility to pursuing third party green building certification.
- Taking a managed approach to procurement of energy in deregulated markets

**Social:**
- A focus on well-being for tenants from design phase through the usage of the building
- Providing tools and resources to engage property managers on sustainability issues
- Encouraging sustainable practices by our tenants through the deployment of tenant engagement tools relevant to each property type

The implementation of these objectives is integrated into IRE’s acquisition/underwriting process and asset management procedures. Specifically, sustainability objectives at the asset-level are identified and prioritised (based on market, tenancy and regulatory conditions as well as asset strategy) as part of the annual business plan and budgeting process.
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Core principles for ESG integration

We believe that any regulatory framework regarding the integration of sustainability risks should be high-level and principles based to allow for and also encourage the breadth of approaches adopted by investment managers, as this reflects the diversity of the investment management industry and the strategies, asset classes and geographies they are investing in.

Based on our experience of ESG integration, we believe that the following principles should help guide the development of a framework for sustainability risks:

Defining a clear ESG philosophy built around the fund’s investment philosophy

At Invesco, we believe that ESG integration starts with defining and articulating a clear ESG philosophy. While each of our investment centres are free to define their ESG philosophy, which is tailored on the basis of investment strategy, asset class, sector and geography, we believe it’s important that each relevant investment centre is able to clearly articulate their philosophy and how it takes into consideration financially material ESG considerations. This means that ESG factors are considered alongside financial factors and these are treated holistically by the investment team to support better-informed investment decisions.

Approaches may differ, from focusing on financially material ESG issues in fundamental analysis to considering ESG momentum. The range of ESG issues that could be considered is vast and the key to a strong ESG philosophy is for each investment team to define what matters most to them and what will be the key driver of performance over the long-term. Regardless of the approach used, we believe that it must be based on quality data and subject to robust challenge and oversight.

Our approach to ESG integration considers ESG factors more broadly, rather than solely focusing on sustainability risks. ESG factors are interpreted as encompassing both risks and opportunities in relation to ESG performance, not only the possible downside. This information is used to develop an ESG score or rating (either by a third party ESG rating provider or based on in-house proprietary analysis). It therefore considers broad ESG performance, not just risks. On the other hand, we would interpret sustainability risks more narrowly as referring to downside risk due to an ESG event. We note that the proposed definition by the Council in the Disclosure Proposal defines a sustainability risk as a “material adverse impact on the value of an investment arising as a result of an ESG-related event”. That said, we believe that a focus on defining financially material sustainability risks in the context of the investment strategy should be the cornerstone of sustainability risk integration.

A robust methodology built on reliable data and analysis

Invesco consumes ESG data and ratings from a broad variety of ESG providers. On the basis of this external ESG data, investment centres will apply their own proprietary analysis or methodologies to deliver their ESG philosophy. This data serves as a tool to flag areas in need of further investigation and provide our investment professionals with additional insights to better enable them to identify and assess ESG issues when they take positions.

However, despite the multitude of ESG data sources available, one of the barriers our investment professionals face is the lack of high quality data that has extensive breadth across companies and countries, as well as time. While data coverage by third party data providers has improved, gaps persist. This includes issues relating to the timeliness of the data (for example, the most recent carbon dataset available is for 2016) as well as coverage of unlisted companies and the fact that data collection methodologies have changed over time and therefore are not comparable across time series. We also encounter significant divergence of approach between external ESG rating providers, which means that the analysis can differ greatly between ESG rating providers or even contradict each other. Finally, we have found that the cost of acquiring such data has increased significantly over recent years.

We believe that addressing these data gaps should be a priority for policymakers as part of the Sustainable Finance agenda.
Effective engagement and stewardship

The hallmark of Invesco’s ESG approach is active ownership. We believe that active ownership and engagement is the singular most effective mechanism to drive responsible investment and strong investment stewardship. This involves purposeful engagement with corporates and proxy voting, depending on the asset class. We believe that engagement should be focused on outcomes to enable and support a substantial contribution to sustainable development.

In 2017, Invesco voted in 18,000 meetings across 72 markets, covering 80,000 ballots and 210,000 proposals. Of these, Invesco voted in favour of 59% of environmental shareholder proposals, 43% of climate-risk related proposals and 31% of gender diversity related proposals.
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Part 2: response to consultation questions

1: 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 that there is currently little clarity around terminology, with many terms being used interchangeably by some but having more specific meanings by others. As set out in part one, our approach currently considers ESG factors in the broader sense, i.e. it encompasses both risks and opportunities relating to ESG issues, but we would understand sustainability risks as being more specifically referring to the material adverse impact on the value of an investment arising as a result of an ESG-related event, as defined by the Council definition in the Disclosure Proposal. A clear focus on financial materiality is key. The degree to which sustainability risks are financially material relevant to a given investment and fund will vary according to the asset class and investment strategy.

In order to ensure legal clarity, we believe that using a single terminology and definition would reduce the potential for confusion amongst firms and investors. In particular, we would like the highlight that that the term “ESG considerations” and “ESG factors” are used in the context of the MiFID consultation. We also note that the draft advice refers not only to “sustainability risks” but also “factors”, without defining what the difference between these two concepts would be. Such inconsistencies should be reconciled.

2. Do you agree with the proposed amendments relating to the organisational requirements included above following a high-level 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 generally support the high-level principles-based approach suggested by ESMA and would like to emphasise the need for proportionality to apply to these requirements.

However, we would recommend the following changes:

- Alignment between the UCITS/AIFMD and MiFID changes. While the terminology “sustainability risks and factors” is used throughout this consultation, the MiFID consultation refers to “ESG considerations and factors”, as highlighted in response to question 1. Reference should be made to the “materiality” and “relevance”, for example in Article 4. This would ensure aligned with the changes proposed in MiFID, which refers to the consideration of ESG where relevant.

We agree that robust governance and oversight is important, but there should not be a one-size-fits-all approach as this should be built around the relevant sustainability risks and the approach to their integration in the investment process, that will be specific to each investment strategy. In particular, while Compliance and Internal Audit should be involved in the monitoring of internal policies and procedures in relation to sustainability risks, this will need to be adapted to the diverse approaches to sustainability risks implemented by the investment team.

3: 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)?

No, we do not believe that a qualified person should be designated as responsible for the integration of sustainability risks. Our approach to the integration of ESG is a bottom-up approach whereby the investment professionals themselves are responsible for the consideration of ESG as this guarantees the authenticity of the approach. As explained above, ESG integration is most effective when it is built as part of the investment philosophy and each strategy will have its own approach to ESG integration. We believe that the same will apply to sustainability risks and therefore believe that mandating a person at the level of the management company or AIFM to be responsible for the integration of sustainability risks could undermine this diversity and lead to a one-size-fits-all approach that fails to adequately consider the financial materiality of sustainability risks in the context of the investment fund.
4: 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?

We do not believe that further changes are required and believe that further changes would undermine the high-level principles-based approach proposed.

5: Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? In 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 set out in response to question 1, we support the high-level principles-based approach and believe that these requirements should be applied in a proportionate way by firms.

As per our earlier answer, we believe that the terminology across UCITS/AIFMD and MiFID should be aligned and refer to “relevant” sustainability risks.

In addition, we would like to comment on some of the ESMA analysis accompanying the proposed changes. First, we believe that some of the analysis would go beyond a high-level principles-based approach and firms should be free to apply their own approach to sustainability risk due diligence. We believe that the approach described in paragraph 27, in particular, is too granular and would limit the diversity of approaches currently used by market participants. Most investment managers rely on third party ESG data and ratings providers to undertake the type of analysis described in paragraph 27 and therefore may only consider changes to the overall ESG score, rather than changes to underlying indicators.

In addition, there are significant data limitations and therefore the rules should be applied in a proportionate way to take this this into consideration. UCITS and AIFs make investments globally and therefore any framework needs to take into consideration not only the current limitations in relation to data in Europe, but also differing standards in other jurisdictions. For example, in Japan, we find that only 500 out of 4,000 issuers are covered by ESG data providers.

Finally, with regards to paragraph 29, we would like to emphasise that in considering whether the investment decisions of the UCITS or AIF have been carried out in compliance with the sustainability risk analysis, we would like to underscore that engagement should be taken into consideration. We believe that engagement is a more powerful tool than divestment and, in the case of passive strategies where managers have no discretion, it is the only option in order to address sustainability risks.

6: 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?

No, as explained above, we believe that firms will undertake due diligence in different ways and further specifying the rules would limit this diversity of approaches. However, we believe that firms should be able to evidence their approach and ensure effective oversight and challenge.

7: 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 interest that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?

We agree with the inclusion of recitals in relation to conflicts of interest and believe that some examples could be helpful. We believe that one area that could be highlighted is the risk that authorised firms put their own reputation ahead of a client’s interests. In the context of ESG, there is a risk that firms may be influenced by their desire to achieve good ESG scores or ratings and put this ahead of the best interests of the client in terms of delivering on the investment objectives of the fund.
Example 1

An environmental disaster at a mining company leads to significant media coverage of the disaster. The price of shares and bonds in the mining company suffer significant initial losses, however, despite discounting the securities to take into account the significant sustainability risk and acknowledging the gravity of the disaster, the fundamental analysis shows that the affected securities were trading below this discounted valuation and therefore appear undervalued. This represents an opportunity to generate returns for clients but could lead to reputational damage for the investment firm. We believe that delivering long-term returns for our clients should be put ahead of any potential reputational issues for the authorised entity.

Example 2

A fund is rated on its ESG performance by an external ESG rating provider, that also provides ESG data. The fund manager disagrees with the external ESG provider’s analysis of Company A’s sustainability risks, based on the fund manager’s own analysis of the company. While the fund manager believes that investing in Company A is the right decision for the fund and its investors, this could lead to a poor ESG score for the fund, leading to possible commercial impacts for the fund manager.

8: 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 do not believe that any further changes are necessary as this would go beyond the high-level principles-based approach proposed.

9: 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 a view in the aforementioned provisions.

We believe that firms should have flexibility as to how they undertake monitoring and oversight of sustainability risks, and this may take the form of risk oversight that takes place within the investment function rather than by the independent risk management function. However, we agree that sustainability risks should be overseen by the risk management function where the fund has an explicit ESG objective.

10: Do you see merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainable 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 the underlying data and methodologies, etc.)?

No, we do not see merit in specifying the content of the risk management policy.

11: 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 limitations, and demonstrate the absence of available alternatives)?

No, we do not see merit in amending these provisions.

12: 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 risks and factors?

No, we would not recommend any changes in relation to risk management.
13: 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 provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

At this stage, it is only possible to provide a qualitative estimate of the resources required to implement the proposed changes. This will include:

- ESG research: Invesco currently leverages more than 10 external data providers, with costs ranging up to 250,000 EUR, as well as undertaking its own internal research.
- IT development: IT systems will be required to monitor funds, risk approached and matching ESG data sources with traditional fund holdings. Changes to the EMT template for product governance will also need to be built in to existing IT systems.
- Staffing and training: Invesco has expanded its team of ESG specialists, as well as training existing staff in ESG issues.