Invesco response to ESMA Consultation Paper on integrating sustainability risks and factors in MiFID 2

February 2019

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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 MiFID 2. 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 employ 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-backed Principles for 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.

Our response to this consultation is formed of two parts: the first part provides an overview of our current approach to responsible and sustainable investing; the second part provides responses to the questions posed in the consultation paper.

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Part 1: Invesco' approach to sustainable investing

Delineating ESG integration and ESG preferences

At the outset, we believe that it is important to make a clear distinction between ESG integration and ESG preferences as there is a risk that the two terms are conflated, leading to confusion.

When we look at the investment landscape today, we draw a distinction between integrated ESG investment strategies and sustainable investment strategies. We believe that the key differentiator between the two is how the investment strategy is defined.

An **integrated ESG investment strategy** has financial performance as its primary 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 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 will focus the investment universe, for example through selecting sectors, companies or projects with positive ESG performance on an absolute or relative basis.

Making this distinction is clear to ensure the right terminology is used. When considering changes to organisational requirements, the focus should be on ESG integration and therefore refer to “ESG considerations”, whereas when looking at product governance and suitability where the aim is to establish the extent to which a client wishes to invest in a sustainable investment strategy, this should refer to “ESG preferences”.

Defining sustainable investment strategies

There is significant confusion in the market today around what constitutes sustainable investing and different terms (for example ESG investing, responsible investing, etc.) are sometimes used interchangeably when they, in fact, mean different things.

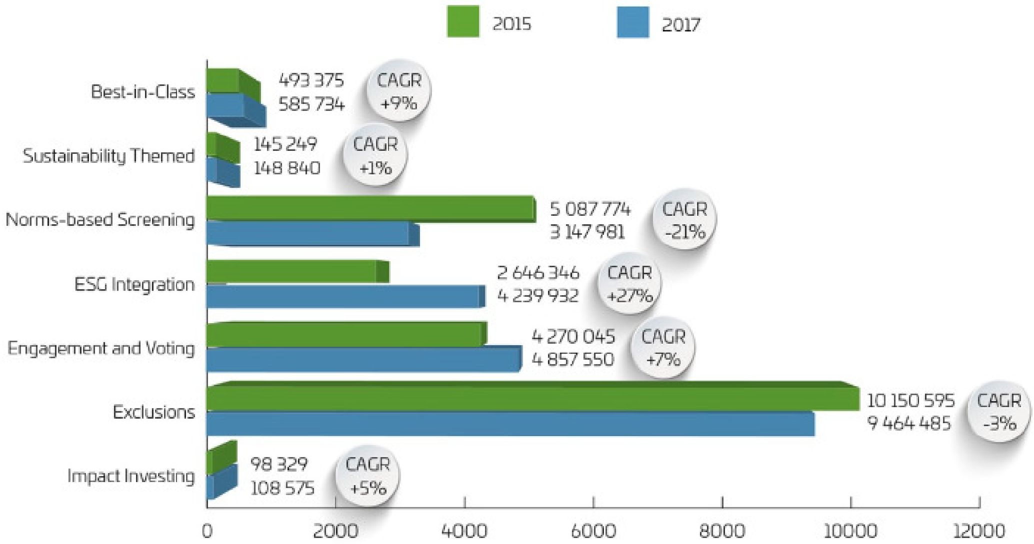
A widely-used classification system broadly defines 7 approaches that fall under the responsible investing umbrella:

1. **Negative/exclusionary screening:** the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria, for example not investing in fossil fuel or tobacco.
2. **Norms-based screening**: screening investments against minimum standards of business practices, typically based on internal norms such as the Un Global Compact, for example not investing in companies that employ child labour.
3. **Positive/best-in-class/ best-in-universe screening:** investing in sectors, companies or projects selected for positive ESG performance relative to industry peers, for example investing in companies ranked in the best 30% in their sector on ESG criteria.
4. **Sustainability themes investing:** investing based on an ESG theme, such as climate or water.
5. **Impact/community investing:** targeted investments, typically made in private markets, aimed at solving social or environmental problems, for example investing assets financing solar power generation.
6. **ESG integration:** the systematic and explicit inclusion of ESG factors into traditional financial analysis.
7. **Corporate engagement/shareholder action/ active ownership:** this refers to the practice of engaging with investee companies on ESG issues.

At Invesco, we believe that a sustainable investment strategy should have an explicit ESG objective, and therefore we believe that only the first 5 of these approaches should be considered as a sustainable investment on a standalone basis. We believe that ESG integration and corporate engagement is a core part of our fiduciary duty as an asset manager and therefore we do not believe that these two approaches, on their own, would constitute a sustainable investment strategy, but should be included as part of any sustainable investment strategy.

When looking at the sustainable investment landscape in Europe today, Eurosif estimates the assets under management in each of the 7 approaches set out above:

European sustainable investing landscape



Source: Eurosif, 2018

Most of the investment strategies currently marketed, either as best-in-class, norms-based or exclusions, are broad ESG/SRI funds and do not target granular E, S or G preferences. Sustainability themed and impact investing funds, while growing, still represent a very small part of the sustainable investment fund landscape. While we find that our clients are becoming more ESG aware and are beginning to request products that target more specific E and S objectives, we believe that it is still too early to move towards a system of defining E, S and G preferences at a granular level. For example, De Nederlandsche Bank's study of the Dutch pension's sector's approach to sustainable investment found that only 11% of pension funds in the Netherlands have a fully integrated investment policy that includes impact investing[1]. 46% of Dutch pension funds focus on exclusions, engagement and voting and best-in-class selection, while another 31% rely on limited exclusions only.

We believe that an effective framework for ESG preferences should ensure that clients continue to be able to access the broad range of sustainable investment products on offer, rather than limiting their choice to specific types of sustainable investment products to ensure that sustainable investment products are integrated as part of their broader investment needs.

Link to the taxonomy

In considering how to define sustainable investing, it is important to consider to what extent the taxonomy should be considered in the process. The taxonomy, as proposed by the European Commission, seeks to define economic activities that can be considered environmentally sustainable.

[1] De Nederlandsche Bank, *Sustainable investment in the Dutch pension sector*, 2016

While such a taxonomy would be valuable for certain investment activities, for example for green bonds or impact investment strategies, its relevance to the broader investment landscape is limited.

In a study commissioned by the European Commission on behalf of the High-Level Expert Group on Sustainable Finance[2], the authors underlined that a "taxonomy would be relevant mostly for targeted finance and investment (representing only a small fraction of total finance and investment worldwide. This implies limited effects on the overall volume of green finance, which, in turn, limits potential environmental impact." The report concluded that "although there is a link between 1) the content of the investment and 2) its impact, there is no strong correlation in the sense that the "greener" the sector, technology or activity is, the more environmental impact the invested money has. **Basing a green finance definition only on "what" is financed thus neglects other mechanisms (e.g. information exchange, shareholder activism) through which investment products might exert influence on the environmental impact of the companies in which they are invested"** [their emphasis].

As set out above, sustainable investment approaches do not only focus on the "what" but also on the "how" and go beyond purely environmental issues to also cover social and governance aspects. They achieve this by considering the ESG impact of companies not solely based on their economic activities but also by the way they conduct their business, including their business practices, processes, etc. They help improve the environmental and social impact of the companies they invest in by incentivising all companies, regardless of their economic activity, to become more sustainable. We believe that this is an important function and should not be de-legitimised by basing a sustainable investment definition solely around the taxonomy.

Furthermore, we believe that there is a need to strike the right balance between the desire to promote the distribution of ESG products and the need to protect consumers. As explained above, impact investing funds (which would be most closely aligned with the taxonomy) may be investing in clean-tech companies that are highly innovative and therefore also riskier investments, and many of these investments are largely focused on private, unlisted assets, which are not UCITS-eligible assets. We therefore believe that building a definition of a sustainable investment fund around the taxonomy could lead to the risk of unsuitable products being distributed to retail investors.

[2] European Commission, *Defining "green" in the context of green finance*, 2017

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Part 2: response to consultation questions

1: Do you agree with the suggested approach and the changes to Article 21 of the MiFID II Delegated Regulation on "general organisational requirements"? Please state the reasons for your answer.

We agree with the high-level principles-based approach suggested by ESMA. However, we would like to point out that there is an inconsistency in the terminology used in the suggested MiFID II changes and those suggested in the AIFMD/UCITS consultation. Here, the term "ESG considerations" is used whereas the term "sustainability risks" is used in the AIFMD/UCITS consultation (and is also referred to in the analysis of this consultation paper). We believe that consistent terminology should be used throughout the regulatory framework, including Solvency II and IDD, to ensure that there is no confusion and that all firms are being held to the same standard.

We believe that sustainability risks should be explicitly defined as the risk of a material financial loss of the value of an asset stemming from ESG issues. Financial materiality is a fundamental principle underpinning ESG integration.

2. Do you agree with the suggested approach and the changes to the Article 23 of the MiFID II Delegated Regulation on "risk management"? Please state the reasons for your answer.

We generally agree with the high-level principles-based approach suggested. As noted in the analysis, such requirements need to be applied proportionately given issues regarding the reliability of data in this area. To underline this point, we would therefore recommend inserting "where relevant" to the changes proposed in Article 23.

Furthermore, we would like to question the relevance of the taxonomy that ESMA sets out in its analysis. The taxonomy, as proposed by the European Commission, will define economic activities that are environmentally sustainable. Economic activities that do not meet the threshold are not unsustainable but merely not categorised. Therefore, the taxonomy will be of no relevance in identifying ESG risks.

3: Do you agree with the suggested approach and the new recital on "conflicts of interest"? Please state the reasons for your answer. What would be the specific examples of the conflicts of interest that might arise in relation to the sustainability considerations?

Yes, we agree with the suggested approach.

4: Do you think that on the topic of "organisational requirements" other amendments should be made to the MiFID II Delegated Regulation in order to incorporate sustainability risks and factors? If yes, which ones? Please state the reasons for your answer.

No, we believe that the suggested changes are sufficient and introducing further requirements risks going beyond the high-level principles-based approach proposed.

5: Which existing market standards or "labels" are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.

We do not currently make use of any existing ESG labels; while we are exploring the use of certain labels, this is driven by client demand. The main challenge we face is the current fragmentation across national lines of the various ESG labels, all of which have different requirements, as well as the limited take-up of some labels. This is why we support the development of an EU ESG label that would provide a single set of standards for ESG products to meet and facilitate cross-border distribution of ESG products. While we recognise that the political imperative to address climate chance as a matter of priority, we were disappointed that the recent consultation on designing a European label was only focused on environmental issues rather than focusing on ESG criteria more broadly.

6: Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Directive Articles on "product governance"? If not, please explain.

We agree with the proposed amendments to the Delegated Directive. However, we disagree with the approach proposed in the accompanying analysis.

As per our explanation in part 1, we do not believe that a system tied to the taxonomy as proposed by the European Commission is relevant to most sustainable investment strategies and risks driving investors into unsuitable products. We therefore do not believe that, at this stage using the classification system in the taxonomy would be useful. Most sustainable investment products currently on the market are broad ESG/SRI funds and therefore expressing ESG as a single preference would be sufficient. Specifying more granular E, S and G characteristics for such funds would increase complexity without adding significant benefit to investors. While we have seen the development in recent years of funds with more granular ESG investment objectives, for example sustainability themed funds targeting one of the 17 Sustainable Development Goals such as climate, use of water, etc., such funds remain a small part of the overall offering of sustainable products. It may be possible that, once finalised, the industry will converge around the taxonomy classification and begin developing products that target investments in those 6 categories, but it is too soon to tell whether this will be the case and whether such a classification system will be meaningful for clients. Therefore, we would not recommend including it at this stage.

More broadly, it is important to recall that the existing target market framework used by the industry, the European MiFID Template, is a highly standardised framework with a limited number of options to facilitate the exchange of information between product manufacturers and product distributors in relation to target markets. We would therefore recommend that a limited number of ESG preferences be defined. Given that many of the existing sustainable products offered today as broad ESG/SRI funds, we believe product manufacturers should have the possibility of defining a broad target market for such funds, with the option to specify a limited number of more granular ESG preferences, such as green, ethical and/or social. Over-specifying the level of granularity in the target market framework will lead to difficulties matching products.

7: Do you agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements and the addition of an additional case study? If not, please explain what changes should be made and why.

While we agree with the proposed changes to paragraph 18 of the guidelines, we do not believe that the proposed case study is a good example of the type of products currently on offer, particularly to retail investors. As explained in part one, impact investing funds of the type described in the case study currently represent a very small proportion of funds currently offered, most of which are targeting institutional investors rather than the retail market. As per our response to question 6, we do not believe that requiring granular ESG characteristics based on the proposed taxonomy would help investors make meaningful ESG choices.

We would suggest the following case study, which we believe better reflects the majority of sustainable funds currently offered to retail clients:

Case Study:

<u>Product: Sustainable investment fund</u>

An open-ended fund with variable capital investing in equities and debt securities globally which meet the fund' s criteria on sustainability. The sustainability criteria include environmental, social and governance (ESG) as well as ethical guidelines. The risk indicator of this fund is 4 on a scale of 7 (medium risk, medium return). The fund is priced daily, and investors can buy and sell shares in the fund every trading-day. A key investor document (KIID) is issued in accordance with the UCITS directive, the KID Regulation for PRIIPs and national law.

<u>Target Market</u>

Type of client: retail, professional clients and eligible counterparties.

Investor knowledge and experience: clients with basic knowledge and experience.

Investor's financial situation with a focus on the ability to bear losses: ability to bear [x]% capital loss.

Risk tolerance and compatibility of the risk profile of the product with the target market: the product has an [x] risk & reward profile and is therefore compatible with clients need to have a medium risk tolerance.

Client objectives and needs:
- Potential of earning positive returns, in terms of both growth and income;
- Specific ESG preferences: positive ESG performance and exclusion of securities based on environmental, social and ethical guidelines, including controversial weapons.

Clients who should not invest (the "negative target market"):
- Clients who are unwilling or unable to accept the possibility of financial loss

Distribution channel

In light of the target market analysis, the product can be promoted widely with or without advice, with no additional restrictions on distributors.

8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.

No, we do not believe that additional guidance is necessary at this stage. As per our response above, we believe that allowing a broad definition of ESG target market would reduce the risks of issues in terms of matching products. In addition, there should be an option for distributors to consider funds that do not match a client's ESG preferences when the investment is part of a diversified portfolio.

9: Please specify any approach you see to identify environmental, social and governance criteria separately from each other or as a single indicator. Please explain how the criteria would interact with each other and how the target market assessment and matching would be performed in such cases.

As per our response above, we believe that ESG preferences should, as a first step, be considered as a single indicator. A limited number of more specific preferences could then be specified in a second step and this could be developed further in the future as this segment of the market develops. The response to the first question would enable the matching between clients with ESG preferences to the broad selection of ESG products on the market. The possibility of defining a limited number of additional optional ESG preferences would then allow flexibility to match products with those more targeted ESG characteristics.

10: What current market standards or "labels" are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.

Please see response to question 5.

11: Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines? If not, do you have any suggestions for developing a more detailed approach with regard to (a) the collection of the information from clients and (b) the assessment of ESG preferences with the assessment of suitability?

While we agree with the need for a high-level, principles based approach, as explained above, we do not believe that ESG preferences should be tied to the proposed taxonomy as we do not believe that it is relevant to most sustainable investment funds currently on the market as it focuses on economic activities, not sustainable investment products as described in the proposed changes to paragraph 28.

Defining the type of questions to be asked will have a significant impact on the way ESG preferences will be considered by clients. In particular, thought should be given to how ESG integrated funds, as opposed to sustainable funds, will be considered within the suitability assessment where clients have expressed ESG preferences.

We fully support the view that ESG considerations should not outweigh the relevance of other suitability criteria and should therefore only be addressed once the suitability had been assessed in accordance with the criteria of knowledge and experience, financial situation and investment objective. We believe that it would be warranted to underline this point in the guidelines.

12: Please specify any approach you see to assess environmental, social and governance criteria separately from each other or as single preferences. Please explain how the criteria would interact with each other and how the suitability assessment would be performed in such cases.

We believe that the approach will vary according to client type. For institutional clients, such clients are likely to have specific ESG preferences that will be implemented in their portfolio on a bespoke basis. For retail clients, the suitability assessment will need to be closely linked to the product governance framework and therefore need to be fairly standardised in order to facilitate matching of products.

13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

Yes, we agree with the suggested approach however we believe the proposed change should refer to “ESG characteristics” to make it consistent with the proposed change to Article 9(11) of the MiFID II Delegated Directive concerning product governance.

14: What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk-management arrangements, market research and analysis, 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, each of which costs between 50,000-250,000 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.

Contact information

[redacted]

[redacted]

Invesco Asset Management S.A Belgian branch
Avenue Louise 235
1050 Brussels
Belgium