

ICMA AMIC Response to ESMA Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD

Introductory Comments

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to this consultation by the European Securities and Markets Authority (ESMA) on integrating sustainability risks and factors in the UCITS Directive and AIFMD.

ICMA has a long-standing engagement on sustainability issues through running the secretariat for the [Green Bond Principles Executive Committee](#), which produces the Green Bond Principles, the Social Bond Principles and the Sustainability Bond Guidelines. However, this response is primarily drafted on behalf of ICMA's buy-side AMIC members.

General comments

AMIC supports the approach that ESMA has taken to integrate sustainability risks in the AIFMD and UCITS Delegated Acts. This high-level, principles-based approach is the right framework for UCITS firms and AIFMs to integrate sustainability risks in their investment processes.

It is important that sustainability risk is treated as a separate (financial) risk from (non-financial) impact risk. AMIC does not believe the technical advice should cover "factors" in addition to sustainability "risks". We believe it is necessary to keep the definition of sustainability risk linked to the financial value side, so references to "factors" and "ESG" should be reduced.

The concept of materiality is also essential to retain in the legal texts, as already reflected in the UCITS and AIFMD framework on risk management, which would now also extend to sustainability risks under the draft technical advice. We believe materiality should also be reflected in the draft technical advice on organisational requirements and operating conditions.

The terms "ESG" and "sustainability" are both used in the text in a manner which can be interpreted as implying that they are interchangeable. This is subject to debate and clearly "ESG" can be read as putting greater emphasis for example on "governance". We understand the immediate priority of the implementation of the EU Action Plan on sustainable finance to be climate change mitigation and adaptation. This is illustrated by the publication of the work to date of the EU TEG on sustainable finance in relation to the EU Taxonomy and to Climate-related Disclosures. Accordingly, we believe that "sustainability" is preferable as a term (i) to avoid confusion about the EU's priorities in the proposed amendments under UCITS and AIFMD; (ii) to avoid the risk of any premature regulatory burden on firms; and, (iii) not to divert the focus of the firm's regulatory implementation.

Responses to questions

Overview

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 partially agree that the definition in Paragraph 17 of the consultation paper should link the concept of "sustainability risk" to the financial value of an investment, although we note that there

are some concerns about the practicality of directly linking sustainability risk with financial value of a position with today's data constraints. We are also conscious that the current legislative negotiations may contain a legal definition of "sustainability risk" (in Level 1) so it is clearly important to have a common understanding across the various legislative requirements to avoid a piecemeal approach leading to various definitions of "sustainability risk".

Whilst we note Paragraph 16 of the consultation paper quotes the Commission's impact assessment whereby sustainability risk is linked to ESG factors ("In this impact assessment, the concept of sustainability is operationalised by referring to so-called ESG factors"), we would prefer "ESG factors" to be replaced by "sustainability factors" for consistency as ESG is not synonymous with sustainability.

In addition, and importantly, the definition of "sustainability risk" cannot easily be linked to the variation in value of a whole portfolio, rather it is more practical to refer to the risk in the loss of value of a particular investment, subject in any case to the availability of data. The definition needs to be amended to reflect this.

Organisational requirements

Q2: Do you agree with the proposed amendments relating to organisational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Yes, ESMA has taken the right approach.

However, we believe it is not necessary to single out sustainability risks. Disclosure requirements currently under negotiation already require fund managers to inform in legal documentation how they address sustainability risks, hence automatically they will have to set up procedures and organisational structures to comply with the disclosure obligation. Also, sustainability risks have to be taken into account as any other relevant risk (risks that are not explicitly mentioned in the organisational requirements), hence singling them out seems unnecessary.

It is not clear to us why the proposal refers to "and factors" throughout the suggested drafts. We understand that the consultation is about integrating sustainability risk (as per the definition provided in paragraph 17 of the consultation paper) and sustainability factors allow the assessment of sustainability risk. Referring to both could be understood to mean that there are two requirements: one relating to the risk and a separate one on the factors. Therefore, we suggest deleting "and factors" throughout the text.

Finally, we believe that, in line with the wording on risk management in section 4 of the consultation paper, materiality should also be included in the amendments to organisational requirements. So, we propose the following changes to the suggested amendments:

- Commission Directive 2010/43/EU Article 4(1)(e) amendment should read: "Member States shall ensure that management companies take into account material sustainability risks when complying with the requirements laid down in the first subparagraph.";
- Commission Directive 2010/43/EU Article 5(5) amendment should read: "Member States shall ensure that for the purposes laid down in paragraphs 1, 2 and 3, management companies take into account the necessary resources and expertise for the effective integration of material sustainability risks.";

- Commission Directive 2010/43/EU Article 9(2)(g) amendment should read: “is responsible for the integration of material sustainability risks.”;
- Commission Delegated Regulation (EU) 231/2013 Article 22(3) amendment should read: “For the purposes of paragraph 1, AIFMs should take into account the necessary resources and expertise for the effective integration of material sustainability risks.”;
- Commission Delegated Regulation (EU) 231/2013 Article 57(1)(e) amendment should read: “AIFMs shall take into account material sustainability risks when complying with the requirements laid down in the first subparagraph.”; and
- Commission Delegated Regulation (EU) 231/2013 Article 60(2)(i) amendment should read: “is responsible for the integration of material sustainability risks.”.

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 think it is necessary to expressly require the designation of a qualified person within an entity. We recognise, however, that understanding and managing sustainability risks can require specialist skills and knowledge, but the decision to designate such experts should be left to firms to decide. Singling out sustainability risks from credit risk or market risk could be disproportionate and could send a wrong signal regarding the importance of sustainability versus other material risks.

Staff at many fund managers will be taking into account sustainability risks. As proposed by ESMA both the risk management team and the senior management will have to comply with such sustainability requirements among many other fund management requirements. In particular, the compliance team will have to ensure compliance with sustainability risks, amongst others.

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, we believe the suggested high-level principle-based approach is proportionate and adequate, given the fast developments in the area of sustainability risks. A more granular approach on sustainability risks would signal a precedence of this risk category over other kinds of risks.

Operating conditions

Q5: Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Yes, we agree with the approach, but firms should be allowed to tailor reporting at the appropriate levels, e.g. both at an investment strategy and at a firm level.

We believe it could be disproportionate to single out sustainability risks from other material risks. Disclosure requirements currently under negotiation already require fund managers to inform in legal documentation how they address sustainability risks, hence automatically they will have to set up procedures and organisational structures to comply with the disclosure obligation. Also, sustainability risks have to be taken into account as any other relevant risk (risks that are not

explicitly mentioned in the organisational requirements), hence singling them out seems unnecessary.

It is not clear to us why the proposal refers to "and factors" throughout the suggested drafts. We understand that the consultation is about integrating sustainability risk (as per the definition provided in paragraph 17 of the consultation paper) and sustainability factors allow the assessment of sustainability risk. Referring to both could be understood to mean that there are two requirements: one relating to the risk and a separate one on the factors. Therefore, we suggest deleting "and factors" throughout the text.

Furthermore, we would suggest adding the words "where appropriate" after "take into account" in the amendments to Commission Directive 2010/43/EC article 23 paragraph 5 and Commission Delegated Regulation (EU) 231/2013 article 18 paragraph 5. This would give more clarity to fund managers. It would mean that the taking into account of sustainability risks should not lead to the automatic exclusion of investments which might not be of a sustainability nature.

Finally, we believe that in line with the changes to risk management obligations, operating conditions references to sustainability risks in relation to operating conditions should reflect materiality.

The two paragraphs would then read:

- Commission Directive 2010/43/EU Article 23(5): "Member States shall require that management companies take into account, where appropriate, material sustainability risks when complying with the requirements set out in paragraphs 1 to 4"; and
- Commission Delegated Regulation (EU) 231/2013 Article 18(5): "AIFMs shall take into account, where appropriate, material sustainability risks when complying with the requirements set out in paragraphs 1 to 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?

No, sustainability risks should be addressed as any other similar risk (e.g. credit risk, market risk, etc), hence singling out sustainability risks would be disproportionate and send a wrong signal as regards the weighing vis à vis other risks. Furthermore, the proposed amendments seem to suggest that sustainability risk is effectively a stand-alone pillar of risk management, whereas we would see material sustainability-related risks as inputs to informing various views of risk (e.g. market, liquidity, credit, counterparty risk, etc.).

Firms should be allowed to develop their own approaches in the first instance, which can be reviewed later as needed.

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?

Yes, we agree with the recitals, although we believe singling out sustainability risks is not necessary as any kind of risk must be considered in identifying conflicts of interest. The (future) requirements on sustainability disclosure explicitly establish sustainability risks as a risk category.

It is not clear to us why the proposal refers to "and factors" throughout the suggested drafts. We understand that the consultation is about integrating sustainability risk (along the definition provided in paragraph 17 of the consultation paper) and sustainability factors allow the assessment of sustainability risk. Referring to both could be understood to mean that there are two requirements: one relating to the risk and a separate one on the factors. Therefore, we suggest deleting "and factors" throughout the text

Furthermore, we do not think there is a need to list specific examples of conflict of interest, such examples could risk leading to a box ticking exercise.

We believe the proposed recitals allow firms to address risks at the investment strategy level and then aggregating these up to a firm level view. Such an approach would be an important means for firms to first identify and then start to manage conflicts of interests within the overall portfolio. Managing conflicts could be done through divestment or via active stewardship (engagement with senior management/Boards) of companies on issues where such risks exist.

Finally, we believe that the recital should refer to material sustainability risks, in line with the proposed wording for risk management in Section 4 of the consultation paper.

Therefore, we propose that the recitals would read as follows:

- Commission Directive 2010/43/EU Recital 17(bis): "When identifying the types of conflicts of interest whose existence may damage the interests of a UCITS, management companies should include those that may arise in relation to the integration of material sustainability risks."; and
- Commission Delegated Regulation (EU) 231/2013 Recital 48(bis): "When identifying the types of conflicts of interest whose existence may damage the interests of an AIF or its investors, AIFMs should include those that may arise in relation to the integration of material sustainability risks."

Q8: Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

No, we believe the suggested high-level principle-based approach is proportionate and adequate, given the fast developments in the area of sustainability risks. A more granular approach on sustainability risks would signal a precedence of this risk category over other kinds of risks.

Risk management

Q9: Do you agree with the proposed amendments to provisions relating to the risk management included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Yes, as it clarifies that sustainability risks can be integrated into other risk categories and gives sufficient flexibility for firms to integrate sustainability risks in a proportionate manner. A more granular approach would risk that firms assess sustainability risks through a box ticking exercise rather than looking at it in a dynamic and holistic way.

We do not believe that sustainability risk is a stand-alone pillar of risk management. We would see material sustainability-related risks as inputs to informing various views of risk (e.g. market, liquidity,

credit, counterparty risk, etc.). In short, we think the best approach to incorporating sustainability into risk management rules is one of integrating sustainability risks into existing risk assessments as appropriate, as opposed to adding requirements to assess sustainability risks on their own.

One way to improve the amendments would be to specify that sustainability risks should be incorporated “proportionate to the availability and relevance of sustainability indicators”.

Article 38 of Commission Directive 2010/40/EU would then read:

“The risk management policy shall comprise such procedures as are necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market, liquidity, sustainability and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for each UCITS it manages.

The management company shall take into account sustainability risks proportionate to the availability and relevance of material sustainability indicators.”

Article 40 of Commission Delegated Regulation (EU) 231/2013, paragraph 2 would then read:

“The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity, sustainability and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.

The management company shall take into account sustainability risks proportionate to the availability and relevance of material sustainability indicators.”

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.)?

No. A more granular approach would risk that firms assess sustainability risks through a box ticking exercise rather than looking at it in a dynamic and holistic way. Also, it might signal that sustainability risks have to be addressed differently than other risk categories, which does not appear justified.

However, firms across Europe are at different stages of sustainability awareness so some guidance could be helpful at a future date. We think there could be merit in setting out some of the means by which sustainability risk integration can be achieved to help accelerate market learning. This could be listed not in a prescriptive fashion but as examples of the kinds of techniques and tools to be used. Examples include stewardship through active engagement or specialist research to supplement off-the-shelf data (such as carbon analysis tools).

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

No. A more granular approach would risk that firms assess sustainability risks through a box ticking exercise rather than looking at it in a dynamic and holistic way. Also, it might signal that sustainability risks have to be addressed differently than other risk categories, which does not appear justified.

While policies should suffice in the short term, to get the market moving, there would also be value in the longer term in promoting regular internal audits and reporting on how these functions are undertaken. Such reporting could enhance transparency and accountability in the market.

Q12: Would you propose any other amendment to the provisions on risk management in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risk and factors?

No, we believe the suggested high-level principle-based approach is proportionate and adequate, given the fast developments in the area of sustainability risks. A more granular approach on sustainability risks would signal a precedence of this risk category over other kinds of risks.

While policies should suffice in the short term, to get the market moving, there would also be value in the longer term in promoting regular internal audits and reporting on how these functions are undertaken. Such reporting could enhance transparency and accountability in the market.

Annex I Cost-Benefit Analysis

Q13: What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk management arrangements, market researches and analyses, organisational costs, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

AMIC cannot respond on behalf of individual firms regarding resources.

ENDS