CONSULTATION ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN THE UCITS DIRECTIVE AND AIFMD

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Finance Watch is an independent non-profit Members' association set up in 2011 to act as a public interest counterweight to the powerful financial lobby. Our mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and citizens. Our Members are civil society organizations and expert individuals, supported by a full-time secretariat.

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We agree to the publication of this response.

1. We understand that for the purpose of the delegated acts adopted under the UCITS Directive and AIFMD, the concept of "sustainability risks" covers the ESG factors which are deemed to be financially relevant for the value of positions in the fund's portfolio. These factors – such as Environmental factors - could become financially material as a consequence of, regulatory developments (such as more stringent environmental policies), technological developments, transition to low carbon economy, etc. In this sense, when referring to sustainability risks, we refer to unsustainable economic activities, because, for example, there could be an expectation that adequate public policies (in terms of quotas, standards or taxes) will be at some point implemented to lead to an internalization of the environmental externalities and so correct the market distortions at their source.

   However, this also means that when we limit the concept of sustainability risk to the financial materiality then all the ESG factors which are not deemed to be financially material (because of lack of strong public policies) are left out, simply because they are expected to remain an externality and so a type of risk which is transferred to the society.

   We would therefore like to remind that a sustainable economic system is a system that imposes no or very few negative externalities, which typically occur in case of environmental goods and therefore we believe that ideally the concept of sustainability risk should also cover all the potential negative ESG impacts that the investments might have. In other words, while we understand ESMA's view, we think that sustainability risk should be seen as a risk with a double nature, one relevant for the fund (in the sense of financial materiality) and one for the broader society (when ESG factors are "material"[1] to the society but not to the fund).

[1] In this context, the concept of materiality means that ESG factors are material to the society because the underlying externalities are causing a decrease in the societal welfare.

2. We are supportive of the ESMA's approach to include sustainability factors in the relevant articles on the organizational requirements.

3. We see a specific merit in expressly requiring the designation of a qualified person for the integration of sustainability risks and factors. This is particularly important because the identification of sustainability risks and their management require a mix of expertise in finance, environmental policies, energy transition, climate change and the different climate scenarios, alternative models for evaluating the risks, etc. For example, in terms of modelling, the standard finance models might not be appropriate for assessing climate risks at micro level and very often a totally different approach (such as scenario analysis) will be required.

4. No.

5. We are supportive with the proposed amendments to the provisions relating to due diligence.

6. We see a merit in further detailing the procedures on the identification and monitoring of sustainability risks. For example, with regard specifically to climate related financial risks (transition and/or physical risks), the following elements are critical in the assessment of material risks:

   - The choice of the climate scenario
   - The time frame of the analysis
   - The (assumed/estimated) probability of occurring of each climate scenario.

   As an example, it is clear that the choice of the climate scenario can have great implications when analyzing the relevant risks. For example, a scenario of 1.5-degree warming will focus more on transition risk, a scenario of 3.5-degree warming will focus more on physical risks.

   In any case, it is critical to set clear boundaries when defining the procedures on the identification and monitoring of sustainability risks, in order to ensure that procedures lead to maximum level of transparency and objectivity when identifying the risks and that all possible relevant risks are adequately taken into account.

7. With regard to the question on conflicts of interest, we are of the opinion that a recital is not enough and that the proposed amendment shall be included in Article 17 of the Directive 2010/43/EU which specifically includes provisions on the criteria for identifying the conflicts of interest.

8. No.

9. Article 38 should clarify that management companies shall take into account sustainability factors for the purpose of risk-management, by specifying the time horizon considered and the perspective from which the sustainability factors are considered. This clarification is very important because what might not be a source of risk for an investment fund could be a risk that is transferred to the society.

   We would also like to point out, that based on the scope of the Taxonomy Regulation, it is not clear how ESMA links the Taxonomy with the sustainability risks discussed in paragraph 35 on page 20. The taxonomy will be a positive list of criteria which will allow to identify economic activities which substantially contribute to one of the environmental objectives listed in the Taxonomy Regulation and could potentially identify “E” opportunities. On the other hand, financial sustainability risks concern those sustainability factors, which could become financially material as a consequence of, among other things, regulatory developments (such as more stringent environmental policies), technological developments, transition to low carbon economy, reputational issues from involvements in socially controversial activities, etc. In this sense, when referring to sustainability risks in finance, we implicitly refer to unsustainable economic activities, which unfortunately are not in the scope of the Commission’s proposal.

We would like to highlight that the Taxonomy should be able to identify economic activities that are green as well as those which are particularly harmful (brown). And that is key for identifying and so managing of ESG risks and opportunities.

Moreover, ESG risks and opportunities shall be adequately disclosed (as climate related financial information should be disclosed in line with the TCFD recommendations).

10. In line with the response to the question 6, we see merit in further specifying the content of the risk management policy.

11. Given that alternative methodologies to the classic models used in finance are required when analyzing sustainability risks and the challenges with regard to the availability and quality of data, it is of outmost importance to amend risk management provisions relating the regular review of risk management policies to more specifically refer to elements related to sustainability.

12. No.