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EACB Position Paper on EC Proposal on amending the delegated acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients.

June 2018

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4,050 locally operating banks and 58,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 210 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 79 million members and 749,000 employees and have a total average market share of about 20%.

For further details, please visit www.eacb.coop

Introduction

The European Association of Co-operative Banks (EACB) is closely following the European Commission work on sustainable finance as this is a very important workstream for the EACB members due to the fact that co-operative banks, being local and regional banks, play a key role in sustainable financing. This is via sustainable investments or savings products, energy transition project financing, green financing to SMEs and energy efficiency financing of private and public buildings or via their social mission: reinvesting significant portions of available profits back into the community. Some co-operative banks are leaders in green bonds. Numerous awards for institutions from the cooperative banking sector are the evidence of this guiding role and also the daily financing of sustainable projects in various regions are part of our business model

This being the case, the EACB and its members would like to once more stress that expressly support all political targets for creating sustainable and climate-friendly regulatory frameworks. These can be achieved via diverse measures to which public authorities, private households and companies should contribute.

As the natural next step in achieving these goals, the European Commission published on 8 March its Action Plan on 'Financing Sustainable Growth' which was very much welcomed. In May 2018, the Commission adopted a package of measures implementing several key actions announced in its action plan on sustainable finance. One of these measures concerns a Proposal on amending the delegated acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients.

In this context, we support the need to raise awareness on this issue and are taking steps towards this direction. However, the EACB is concerned by the European Commission's intention to amend the MiFID II and IDD delegated acts and the relevant ESMA's guidelines in order to mandatorily incorporate ESG preferences and factors in the suitability test/process at this point in time. Other elements of the Commissions package such as the Taxonomy or disclosure requirements on how for example issuers integrate environmental, social and governance (ESG) factors in their risk processes ('Disclosure & Investor Duty'), could be the starting point- that is more towards these issuers rather that non-professional retail investors. This is all the more so, as the first task would in any case have to be to include ESG information regarding the products (at asset manager level with details) that will allow to make the link with client's preferences.

Please find our detail comments below:

Detailed Comments

- *The need to start with a standardized classification system first*

Although the European Commission has published some guiding principles and broadly defined the scope of the classification system for sustainability (taxonomy) by way of a proposal for a

Regulation, the Commission envisages the development of an EU-wide standardised classification system only in the third quarter of 2019- if not later.

In terms of the process, we are fully aware of the reasons why the Commission has proposed a two-step approach for the development of the taxonomy, proposing a regulation first (in May 2018) and having the elaborated details integrated at a later stage. However, this approach needs careful consideration of its cross-sectional influence on other pieces of legislation, and should be consistent; we understand this is as the decisive cornerstone for the whole initiative and therefore urge the Commission to guide this process with its utmost attention.

The EACB subscribes to the view that – first and foremost - a clear and shared understanding is needed of what "sustainable" means and how "sustainable finance" policies should look like.

Once the taxonomy is finalised then targeted amendments and refinement of the legislative framework could be considered. In this way, the client will be able to understand what exactly he/she agrees upon when indicating preference for ESG investing while on the other hand it is clear to banks how to match such preferences against possible investments.

In the meantime, we do understand that it is imperative to already create awareness around this issue and cooperative banks already take steps that that regard.However, this can be achieved without amendmenting the MiFID II/ IDD delagated acts at this stage.

- *An amendment of MiFID II and IDD delegated acts is premature*

In this context, the EACB believes that it is premature that the European Commission plans to amend the MiFID II and IDD delegated acts at the same time as it publishes a first legislative proposal on the development of an EU taxonomy for climate change, environmentally and socially sustainable activities.

Indeed, as reflected above, before introducing any mandatory requirement that investment firms, when providing investment advice, carry out a mandatory assessment of ESG in their suitability process, is necessary to have a common understanding of what climate change, environmentally and socially sustainable investments are. This will ensure legal certainty and a coherent and consistent approach.

Our members support the sustainability objectives, but it should be kept in mind that investment firms have already spent a great deal of resources into the implementation of MiFID II, which only entered in to application on 3 January this year, with some member states still struggling with its implementation. We fear that introducing these changes now would create confusion to the market, could have a negative impact and would jeopardise the work made by the financial sector these last years to implement MiFID II.

In addition, the European Securities and Markets Authority (ESMA) has published its Final Report on Guidelines on certain aspects of the MiFID II suitability requirements on 28 May 2018. In these Guidelines, and following the publication of Action Plan on sustainable finance, ESMA has already included a good practice for firms addressing this issue.

It should be also pointed that a MiFID II review is due early next year.

- *<u>Practical, technical and legal challenges in introducing this mandatory requirement prematurely.</u>*

Changing or adapting the suitability assessment process is not an easy task:

First and above all, it would require designing a categorization system for different products on the basis of sustainability characteristic or the lack of such. This cannot be done without a proper taxonomy and in any case would require significant amount of time.

It would imply an update of the whole product governance process including the Target Market. For example, manufacturer would have to be able to flag the products to the distributors to allow them to identify them as suitable and this requires a reorganisation of their communication.

It would require not only changing the questionnaires but also a modification of the IT systems. And to adopt the systems it would in turn require firms to have all relevant data. These data would allow firms to link the information requested from the with products. That means that this process would need to start from the manufacturers to include ESG information regarding products (at asset manager level with details) that would as a next step allow matching products with client preferences.

In addition, EACB fears that this would have to be done twice, that is one time now and again once the EU taxonomy has been adopted.

All these measures cause a further huge bureaucratic burden and make considerable changes in the internal MiFID advisory policies and procedures of the institutions - that have been implemented only recently - necessary. We have reservations in terms of both method and timing that might lead to unintended consequences. Therefore, we would welcome an impact assessment on the parts of the Commissions package where not yet provided.

Against that background, we consider that a consideration of the clients' ESG preferences in the investment and advisory process shall be provided for the institutions on a voluntary basis only- until the EU taxonomy has been established.

- *<u>No reason to further legally prescribe the inclusion of ESG considerations in suitability tests at this stage</u>*

The duties of care, loyalty and prudence are embedded in the EU's financial framework governing obligations that bank, investment firms, institutional investors and asset managers owe to their clients, end-investors or scheme members. Sustainability factors can serve as an additional parameter for evaluating the long-term performance of companies and projects and their consideration -where possible, relevant appropriate. That is why, financial institutions and investment entities are increasingly seeking to integrate sustainability factors in their investment process and decisions and to monitor and mitigate their risk where necessary. In this context, the suitability assessment process is a key step in finding out essential facts about the client to determine their investment objectives.

As part of this duty, financial institutions and investment entities increasingly seek to integrate sustainability factors -where such integration is relevant and material- in their investment process and decisions and to monitor and mitigate their risk where necessary. Sustainability factors can serve as an important parameter for evaluating the long-term performance of companies and projects and their consideration -where appropriate- ensures acting in the best interest of clients and protect clients' investments over the long-term.

In particular, co-operative banks are based on lasting relationship to private customers and enterprises that is naturally long-term orientated. Their success depends strongly on the economic, ecological and social wellbeing of their operating area. This naturally leads intermediation by cooperative banks to more likely meet economic and social sustainability requirements. As a result, a demand for sustainable financial products has already arised that can also be met by the co-operative banks.

This is why from a co-operative, retail and locally focused institutions' point of view, we think that it is important to highlight the fact that "sustainable" finance is already being carried out in Europe through banks' balance sheets, mostly putting deposits at work for the benefit of the real economy.

Given the current environment, the EACB does not necessarily see an imperative to further legally prescribe in a rigid manner the incorporation of ESG factors in the suitability test at this state. This can be done on a voluntary basis only.

We fear that a mandatory legal requirement could prove counterproductive, as there is a danger of over-simplification of a very complex issue with different dimensions and with sustainability considerations evolving overtime. This should not become a tickbox excercice but allow felxibility and proportionality. Any one-size fits all approach would limit the possibility to act according to specific investors' situation and would introduce aspects of a planned economy into a market economy. This is all the more so considering that there is no common taxonomy for sustainable assets established yet.

Proposed way forward

In order to do this right, avoid unintended consequences and market disruption, avoid unnecessary burden and costs, and ensure legal certainty we urge the European Commission to reconsidered its timetable for the implementation of the action plan on financing sustainable growth in this regard.

Amending the delegated acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients in a mandatory way should only be considered once a taxonomy has been established.

We would urge the Commission to finish the taxonomy first and afterwards introduce amendments to the suitability requirements where necessary- allowing for enough time to implement these. A timeframe of at least 18 months from the time the taxonomy has been established would be considered adequate in that regard. Indeed, it is crucial to link the start of the transitional period to a complete Taxonomy.

Some additional considerations

- The understanding of what is "in the best interest of the client" is a rather subjective notion. And whilst advisers and other fiduciaries may in general (seek to) integrate sustainability factors in their investment process and decisions, this is always subject to 2 additional conditions namely (1) this is intended and supported by their clients (2) the impact on the financial return is appropriately considered.
- It is also important to consider the differences between the role, influence and purposes of the different actors in financial markets, bearing in mind that clients and asset owners are the ones to ultimately set their investment objectives and wishes. The investors`s selection of a suitable investment product is based on varied needs shaped by his or her individual values and investment goals.
- Taking a practical perspective, experience had shown that if (retail) clients have too many options they tend to get confused. This means that it should be considered that guiding them with specific limited options to sustainable investments/product could be desired at least at the first stages.

Contact:

The EACB trusts that its comments will be taken into account.

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