DDV Response

to the ESAs Joint Consultation Paper on ESG Disclosures

Executive Summary

- We call on the ESAs to avoid exclusively focusing the draft RTS on issuers of "financial products" within the meaning of the SFDR (in particular, investment funds and insurance undertakings), and also to take into account *financial instruments* that are not financial products but are recommended to clients with an ESG preference pursuant to the suitability test regime under MiFID II. This includes, in particular, Sustainable Structured Investment Products (SSIPs) issued by banks in the legal form of a bond (i.e., a financial instrument under MiFID II but not a financial product according to the SFDR). This could also be a useful exercise with a view to a (possible) future alignment of the scope of application of the SFDR and MiFID II.

- The draft RTS should be streamlined with reporting requirements according to the Non-Financial Reporting Directive (NFRD) under the Taxonomy Regulation. The draft RTS clearly go beyond what is feasible with regard to the availability of data. The ESAs could exert their political influence at Level 1 to broaden the scope of the NFRD in the future. In the meantime, the ESAs should follow a principle-based approach, requiring from market participants meaningful governance of the sustainable investments/characteristics embedded in their products instead of focusing on purely quantitative indicators.

- When purchased by investment funds and portfolio managers, SSIPs should be classified as bonds and not as derivatives. SSIPs can be generally split into two components, whereby the "bond component" usually outweighs the "derivative component" with regard to the use of proceeds.

- It would be appreciated if the ESAs could give additional guidance as to how the notion of "promoting environmental and social characteristics" (Article 8 product) compared to "sustainable investments" (Article 9 product) is to be understood. This is of particular importance when deciding on the appropriate guidance for retail investors to allow them to distinguish between one product and the other.

- Furthermore, the ESAs should provide further guidance (following the helpful indications given on pp. 14-15 of the Consultation Paper) on the relation of adverse impacts according to the SFDR to the Do No Significant Harm (DNSH) principle under the Taxonomy Regulation.

I. General Remarks

The DDV welcomes the opportunity to reply to the ESAs' "Joint Consultation Paper on ESG disclosures - Draft regulatory technical standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a, Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088". The DDV recognises that the alignment of the real economy towards sustainability is one of the most important and demanding challenges of today's global society. The members of the DDV are willing to contribute to this objective and have been actively involved in standard setting for sustainable investment products for almost two years. Even though the DDV is of the opinion that financial legislation on its own will not be sufficient to fulfil the full potential of the sustainable finance agenda, disclosure on sustainable financial products is definitely an important step that can be taken to encourage retail investors to become engaged in a meaningful way.

That said, responding to this consultation is a challenging exercise. In addition to the highly prescriptive approach taken by the ESAs and the complexity contained in the draft RTS (specifically in Annex I), misalignments at Level 1 result in inherent consequential problems at Level 2, which strongly impair a level playing field for the manufacturers of sustainable financial instruments. In particular, the draft RTS cannot be assessed against the background of a uniform product definition at Level 1, but rather on the basis of a regulatory patchwork: the term "financial product", which determines the scope of application of the SFDR and thus of the draft RTS, is not congruent with the term "financial instrument" under MiFID II, which is decisive for the target market definition and the suitability test in investment advice and portfolio management. Moreover, some "financial products" qualify as a PRIIP under Regulation (EU) No 1286/2014, while some do not (e.g., individual portfolio management), and there are products that qualify as a PRIIP, but not as a "financial product" (e.g., structured investment products issued as bonds). The transparency requirements specified by the draft RTS therefore apply from the outset only to a part of the MiFID II and PRIIP product universe. In particular, they are not applicable to bonds, such as green bonds or green structured bonds, which qualify as financial instruments under MiFID II and – at least the latter – as PRIIPs.

Why does this pose a problem from a DDV perspective?

The current drafts of the Delegated Acts amending the MiFID II Delegated Regulation (EU) 2017/565 and the MiFID II Delegated Directive (EU) 2017/593 require that financial advisers and individual portfolio managers explore the potential "sustainability preferences" of their clients before rendering investment advice or portfolio management. On the one hand, the notion of "sustainability preference" uses the nomenclature of the SFDR, by making reference to Article 9 products ("sustainable investments") and Article 8 products ("promote environmental or social characteristics"). On the other hand, the exploration of the client's "sustainability preferences" is not limited to financial products but encompasses the whole range of *financial instruments* irrespective of their qualification as financial products under the SFDR. As a consequence, financial advisers or individual portfolio managers can be allowed (or are even supposed) to recommend a client with an ESG preference a financial instrument (such as a green bond) – although it is not a financial product – as long as it complies with the sustainability features set out in either Article 8 or Article 9 of the

SFDR. To be able to do so, the financial advisers or portfolio managers have to rely on information provided to them by product manufacturers (e.g., in the case at hand, the issuer of the green bond), which gives them assurance that the green bond actually complies with Article 8 or Article 9 of the SFDR transparency requirements. In other words, we expect that issuers of the green bonds have to (at least to some extent) de facto comply with the SFDR and the draft RTS if they would like their green bonds to be eligible for the ESG suitability test under MiFID II. Accordingly, one would expect that the ESAs' draft RTS would reflect not only the typical features of financial products but also of other financial instruments, such as bonds. However, it does not. This is of great concern to us because we believe that the concept of a level playing field for all product manufacturers is at risk here. Furthermore, bearing in mind that the European Commission's Renewed Sustainable Finance Strategy has put all Level 1 sustainable finance legislation under review, it cannot be excluded that the scopes of applicability of the SFDR and MiFID II will be aligned in the near future. Although the ESAs are not in a position to anticipate this political outcome, we believe that the ESAs should already be pursuing an "open architecture" approach rather than an exclusive approach when designing the draft RTS. This could help the draft RTS adapt to new legislative developments at Level 1, instead of requiring a total recalibration of the whole concept. At the same time, this is the reason why we are taking the opportunity to respond to the present consultation even though manufacturers of structured products are not currently subject to the SFDR.

Before responding to selected questions, we would like to take the opportunity to remark on the current regulatory setting in general and on the draft RTS in particular from the point of view of manufacturers of structured products, which shall in the following (and due to the reasoning set out above) be regarded as if they were financial products within the meaning of the SFDR.

1. <u>ESG disclosures in the context of Sustainable Structured Investment Products</u>

When it comes to structured products, different components need to be considered with regard to the use of proceeds.

SSIPs can usually be split into two components. A "bond component" and a "derivative component" linked to a sustainable underlying. Both components should be assessed separately and then be aggregated for disclosure reasons.

Again, the DDV calls on the ESAs to avoid exclusively focusing the draft RTS on issuers of "financial products" within the meaning of the SFDR, and also to take into account financial instruments that are not financial products but are recommended to clients with an ESG preference pursuant to the suitability test regime under MiFID II. At the same time, consideration should be given to the nature of structured products as stipulated in Article 8(3) as well as Article 9(5) of the SFDR, where it is stated:

"When developing the draft regulatory technical standards referred to in the first subparagraph, the ESAs shall take into account the various types of financial products, their characteristics and the

differences between them, as well as the objective that disclosures are to be accurate, fair, clear, not misleading, simple and concise."

Even though the DDV is confident that any disclosure requirements applicable to funds are generally also viable for SSIPs, we encourage the ESAs to have different financial instruments already in mind particularly with respect to the "disclosure architecture" and the specific regulatory anchor (e.g., the Prospectus Regulation with regard to SSIPs).

It is very important to recognise that, although SSIPs have a derivative component, this asset class first and foremost should be classified as a bond and not as a derivative. Accordingly, SSIPs should be an integral part of the ESG disclosures when purchased by investment funds and portfolio managers subject to the SFDR.

2. <u>The benefits of Sustainable Structured Investment Products for retail clients</u>

Structured products offer unique options for participating in sustainable investments that need to be recognised. This is of particular importance in a highly dynamic market segment.

As structured investment products, SSIPs are (often non-linear) passive investments with regard to their pay out profile. Their structuring basically serves the function of adjusting the risk-return profile independent of the choice of a specific underlying. We would like to highlight the fact that a large amount of structured products, in particular those classified as "investment products" (i.e., products that are recommended by financial advisers to their retail clients), reduce the risk for the client (we estimate this to be the case for 60-65 percent of "open interest/assets invested"). This characteristic, combined with the option of individually choosing between many different underlyings, offers unique possibilities for end investors and retail clients in particular. The latter generally either do not have access to sophisticated financing techniques or do not have the necessary resources to build up portfolios corresponding to their risk-return preferences in a cost-efficient manner. Structured products incorporate those techniques building on the infrastructure of issuers/product manufacturers and making use of economies of scale, thus lowering transaction costs while allowing investors flexibility and freedom of choice with regard to their individual investments. This might become of particular importance in the context of sustainable finance, especially with regard to mainstreaming various ESG strategies and techniques in a market segment that has been highly dynamic.

3. <u>The contribution of Sustainable Structured Investment Products to the sustainable finance agenda</u>

The positive effects of SSIPs due to their bond component as well as their indirect investment effect (ultimately leading to direct primary financing of companies, including non-listed companies such as SMEs) should not be underestimated. However, the focus of the draft RTS on comparability, resulting in very detailed and often quantitative indicators, bears a risk of creating bias in favour of the equityfinancing of listed companies. In addition, product definitions remain unclear, which makes it difficult to position different types of products.

As described above, an (often considerable) part of the proceeds of a SSIP remains on the balance sheet of the issuer for other funding purposes than (indirectly financing) the underlying determining the payout profile. They might also serve, for example, for the allocation of loans. Hence, the sustainability of the issuer in general needs to be assessed.

Taking the example of what we call a "Structured Green Bond", a SSIP where the bond component follows recognised market standards or even standards provided by regulators (e.g., the current version of the EU Green Bond Standard) while adding a "derivative component" in order to make this financial instrument more attractive and accessible for retail investors. The (increasing) demand of retail clients for SSIPs will thus incentivise issuers to successively increase their exposure to eligible investments for these products. This can also be applied to bonds issued by banks without a specific thematic focus where the general ESG performance of the issuer needs to be assessed. Again, the demand of the client for these kind of products will ultimately lead to an ongoing "race to the top" of issuers with regard to their ESG performance. The DDV believes the gradual transformation of the economy as a whole to be a very important political objective of the sustainable finance agenda.

The DDV would like to draw attention to the fact that we expect EU-wide (or even better, international) market standards with regard to the assessment of bank financing to evolve in the near future. For instance, the UN Principles for Responsible Banking were launched in September 2019, and we expect this framework to play a more prominent role in the years to come. Also, the market for sustainability linked loans and bonds is developing in a dynamic manner, followed by market standards such as the ICMA's Sustainability Linked Bond Principles, which were published only in 2020. In addition, several regulatory as well as supervisory requirements touching upon the integration of sustainability risks will certainly lead towards a harmonisation of strategies followed by methods and processes, and, finally, specific indicators.

We expect these developments also to be reflected in the methods used to assess the ESG quality of issuers. In the meantime, we believe that a principle-based approach with regard to strategies and processes (ESG governance) is needed before focusing on individual, rather narrow quantitative indicators that may turn out to be unreliable (because of lacking data) or incomparable (because of non-standardised methodologies) and could finally lead to significant legal uncertainty and disproportionate liabilities.

With regard to the "derivative component" of a SSIP, the DDV would like to draw attention to the fact that an assessment should be done with regard to the ESG eligibility of an underlying (where relevant), where the EU Taxonomy provisions would obviously be taken into account. This description should be part of graphical and narrative explanations with regard to the ESG quality of a financial instrument.

The DDV is convinced that, even though an investment might be "indirect" through the use of derivatives, the usage of those instruments (e.g., options and futures on an eligible underlying) significantly contributes towards the sustainability agenda.

We would like to refer to a study by Lannoo and Thomadakis (2020) on the roles of derivatives in sustainable finance, which not only emphasises the key role of derivatives as a general risk management tool, but also sheds light on their major role in enhancing transparency (information on the underlying), thus facilitating price discovery and ultimately increasing market efficiency. These roles ultimately contribute to long-term sustainability objectives.

In addition, derivatives create immediate effective demand for the underlying, as the counterparty for a given derivative contract is required to directly purchase the underlying the contract refers to in order to fulfil its obligation at the end of the contractual period. Hence, the price of the sustainable underlying will rise. This ultimately enables the issuer of the underlying to raise more and cheaper capital for its sustainable activities. Needless to say, any "direct" secondary market transactions in bonds and shares have basically the same effect.

II. Answers to the Consultation Paper

Question 1: Do you agree with the approach proposed in Chapter II and Annex I – where the indicators in Table 1 always lead to principal adverse impacts irrespective of the value of the metrics, requiring consistent disclosure, and the indicators in Table 2 and 3 are subject to an "opt-in" regime for disclosure?

The DDV does not agree with the approach proposed in Chapter II and Annex I.

In our opinion, the adverse indicators do not lead to reliable and comparable results. Furthermore, the required data are (to a large extent) not yet available. The DDV also wishes to stress that the materiality of indicators should be taken more clearly into account. While some indicators may indeed be considered to always lead to principal adverse impacts (PAIs), not all indicators are relevant to all financial market participants or products.

We believe that the regulatory approach should be more balanced, allowing for a qualitative evaluation of principle adverse impacts and the governance of the latter within a financial product, while reducing the set of mandatory indicators significantly.

In addition, PAI indicators need to be streamlined with the yet to be defined DNSH indicators in the Taxonomy Regulation, as well as with the reporting requirements of the NFRD. Over time, a phasing-in of other indicators could be considered.

The DDV takes a rather critical position on the proposed opt-in regime, since market participants could choose different sets of indicators, which does not enhance comparability for investors and would be difficult to handle for financial market participants (especially portfolio managers) when aggregating these indicators for different financial instruments.

Finally, we would like to draw attention to the fact that, since funds of structured products are also used to finance non-listed companies (see I. General Remarks above), the data gap becomes even more severe. It would be impossible to check for the proposed adverse indicators with regard to the existing credit portfolios unless the borrower – often a non-listed company – is obliged to deliver the data. This, however, is not even foreseen for the near future.

Question 16: Do you think the differences between Article 8 and Article 9 products are sufficiently well captured by the proposed provisions? If not, please suggest how the disclosures could be further distinguished.

The DDV is of the opinion that the definitions are not sufficiently clear and that investors will have difficulty grasping the difference between both types of products. What exactly distinguishes "sustainable investments" from those "promoting social and environmental characteristics"? And how is this linked to the Taxonomy Regulation? This poses a particular challenge regarding potentially overlapping definitions. The proposed changes to the MiFID II Delegated Directive and to the MiFID II Delegated Regulation make things even more confusing, where "sustainable investments" for products according to Article 8 of the SFDR are required (if the PAI are not considered), though the Level 1 provisions of the SFDR do not stipulate such a requirement.

We believe that a clear delineation is necessary between both types of products and that both types of products should be recognised to contribute to the transition towards an increasing sustainable economy. Having said that, only when the delineation of the different kinds of products is clear enough can proper guidance for retail clients be formulated, which, in any case, should abstain from stigmatising any product at the point of sale. Both types of products have to define clear ESG objectives, indicators, and metrics, and report on these.

In addition, according to Article 16 of the draft RTS, products in accordance with Article 8(1) of the SFDR should make a statement that "this product does not have as its objective sustainable investment", while also stipulating for the same product that "where a financial product invests in a sustainable investment" additional explanations should be given. This provision in itself does not appear to be very consistent, as financial products that invest in sustainable investments would still need to carry the disclaimer that they do not have sustainable investments as their objective (thus investing into sustainable assets only by default?). This, we assume, would be difficult for retail investors to understand.

Question 17: Do the graphical and narrative descriptions of investment proportions capture indirect investments sufficiently?

Given that the notion of “indirect investments” covers a broad range of different investment concepts, the requirement to provide for graphical and narrative descriptions as set out under Articles 15(2) and 24(2) should be applied in a way that allows for sufficient flexibility. We would like to illustrate this with the following example: While SSIPs are commonly issued as bonds (and, therefore, should be regarded as bonds and not as derivatives), parts of their proceeds create effective demand for an ESG-eligible underlying. In such cases, the “indirect investment” deriving from derivatives contracts with ESG-eligible underlyings should be explained in the narrative explanation while the graphical representation should inform the investor about the proportion of sustainable and non-sustainable “overall” use of proceeds of the SSIP.

It is our understanding that this presentation concept would be in line with the requirements set out in Articles 15(2) and 24(2). If the ESAs agree with this understanding, we do not see a need for any further specific provisions on “indirect investments”.

Question 26: Is it better to include a separate section on information on how the use of derivatives meets each of the environmental or social characteristics or sustainable investment objectives promoted by the financial product, as in the below draft RTS under Article 19 and article 28, or would it be better to integrate this section with the graphical and narrative explanation of the investment proportions under Article 15(2) and 24(2)?

As explained in our answer to Question 17, derivatives embedded in a SSIP are used to gain exposure to an ESG-eligible underlying, creating effective demand for the respective ESG underlying (see also our General Remarks above in I.). In this case, the proportion of exposure to that underlying should be allowed to be disclosed within the graphical and narrative explanations (see our answer to Question 17). If the ESAs share this view, we do not see the need to have a separate section in addition to the graphical and narrative explanations provided for under Articles 15(2) and 24(2). In this context, the DDV would like to reiterate that SSIPs should first and foremost be classified as bonds and should not be treated as derivatives, even though derivatives might provide for indirect exposure to ESG-eligible assets in bonds and shares purchased through secondary market transactions (see also our General Remarks above in I.).