

BlueBay Asset Management LLP: Response to the ESMA Consultation Paper on Integrating Sustainability Risks and Factors in MiFID II

February 2019

Introduction

BlueBay Asset Management LLP is one of Europe's largest specialist active fixed income managers, entrusted by clients with over US\$60.1 billion in assets under management (as of 31st December 2018) in corporate and sovereign debt, rates and FX. Our investment philosophy and approach is focused on delivering absolute-style returns, with an emphasis on capital preservation. We have an established track record of innovation and performance, providing a broad range of relative return, total return and alternative investment portfolios in both public and private debt markets.

We welcome the opportunity to respond to this ESMA public consultation. Investment analysis of non-financial factors – commonly referred to as ESG (environmental, social and governance)* factors – encompasses those aspects of an issuer's practices that influence its ability to meet its financial obligations. BlueBay believes that ESG factors can potentially have a material impact on an issuer's long-term financial performance. Given the limited upside (and potentially significant downside) of fixed income investments, the focus of our ESG analysis is on understanding downside risks. Poorly-managed ESG risks can lead to inefficiencies, operational disruption, litigation and reputational damage, which may ultimately impact an issuer's ability to meet their financial responsibilities. Supplementing traditional financial analysis by reviewing ESG-related management practices and performance is, therefore, not only prudent but also in line with BlueBay's fiduciary duty to optimise investor returns. There is also increasing recognition that as some ESG factors can potentially represent systematic financial risks, ensuring a sustainable financial market is critical to avoid potential financial crises.

Whilst consideration of such factors has always been a feature of BlueBay's investment activities, since 2013, we have been conducting this in a more strategic and systematic way. We recognise investors and other key stakeholders are increasingly requiring managers such as BlueBay to demonstrate to what extent ESG factors are relevant to, and an important feature of, our investment process, and we are committed to being open and transparent about our position and efforts in this regard. We believe this is critical to facilitating informed choice for investors as to how they wish to invest their assets, including directing capital towards strategies which more proactively and explicitly factor in ESG issues.

As such we are supportive of initiatives which promote transparency as a core principle. We believe a high-level, principles-based approach is most appropriate. Whilst it may be helpful to provide suggestions on what good/best practice looks like on incorporating ESG factors into investment activities, these should be applied with the proportionality principle in mind as there may be circumstances where this may not be relevant or appropriate the proportionality principle e.g. to account for the size, nature, scope and complexity of a manager's activities and the investment strategies they employ. The field of ESG investing (which can encompass responsible investing, and sustainability investing) is broad ranging and rapidly evolving given it is still in its infancy. An approach to regulation which is principles-based in such a dynamic field can avoid stifling innovation or being too onerous, whilst delivering effective and efficient outcomes.

** BlueBay considers, and uses, 'ESG' as a term that is synonymous with 'sustainability' which is used in this consultation. For us, both refer to non-financial (or extra financial) factors.*

Responses to questions

Q1: Do you agree with the suggested approach and the changes to the Article 21 of the MiFID II Delegated Regulation on 'general organisational requirements'? Please state the reasons for your answer.

We are supportive of a high-level, principles-based approach relating to general organisational requirements. Whilst it may be helpful to provide suggestions on what good/best practice looks like regarding general organisational requirements, we believe these should be framed around a 'comply or explain' approach rather than being prescriptive in nature. There may be circumstances where such suggestions may not be relevant or appropriate e.g. to account for the size, nature, scope and complexity of a manager's activities and the investment strategies they employ. We believe the content of the existing regulation allows for this.

Generally speaking, individuals involved in the advisory process should have a base level of skills, knowledge and expertise on ESG investment related factors in order to effectively support investors in making their investment choices.

Q2: 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 are supportive of a high-level, principles-based approach relating to general organisational requirements. Whilst it may be helpful to provide suggestions on what good/best practice looks like regarding general organisational requirements, we believe these should be framed around a 'comply or explain' approach rather than being prescriptive in nature. There may be circumstances where such suggestions may not be relevant or appropriate e.g. to account for the size, nature, scope and complexity of a manager's activities and the investment strategies they employ. We believe investment managers are best placed to know what to include in risk reviews.

Broadly speaking, with ESG related factors becoming increasingly important for financial markets and to society at large, a risk management approach that also considers more explicitly and directly ESG related factors may result in a more holistic assessment, and be potentially better placed to mitigate against risks.

Q3: 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 specific examples of conflicts of interests that might arise in relation to sustainability considerations?

This could be useful to draw attention to potential conflicts of interests, which can then be managed by ensuring appropriate checks and balances. We are sensitive to concerns about potential for mis-selling practices or misrepresentation (specifically 'green washing' as it relates to ESG investing), which can damage confidence in the industry. Ensuring public transparency is key to promoting accountability and building trust. We welcome the recognition of having the proportionality principle in mind.

Q4: 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.

Not at this time. Although more generally we would be supportive of a revision in the use of 'sustainability' in the amendments to the regulation, and would suggest this be replaced with 'ESG' as we believe this to better represent the factors referred to and is more consistent with the terminology used in the marketplace.

Q5: 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.

Currently, we do not formally take into account, or subscribe to market standards or 'labels' as they relate to ESG factors. We recognise such initiatives can potentially be useful for investors looking to better understand and differentiate between investment offerings to aid in selecting those that best meets their needs. However, as the field of ESG investing encompasses a spectrum of different ESG investment strategies, some primarily focussed on investment material ESG risks and others on ethical considerations, some operating based on negative exclusions whilst others on positive inclusion, and others being focused on a single theme (e.g. environmental) with others be in multi-thematic, some labels may be too narrow in their focus and their application could, therefore, lead to confusion and undermine their existence. It may be legitimate that a product does not meet a stated criteria for a particular label, as that was not what that product set out to do. In addition, given how dynamic the ESG investing field is, labels risk becoming outdated. As such, were a label or taxonomy to be adopted as a reference/benchmark for ESG investing, this should be as broad as possible to reflect the reality of ESG investing in practice, and not be prescriptive.

Rather, we are supportive of initiatives that seek to promote transparency of the nature of investment products with regards to ESG factors, the processes in place to implement this, and the resulting performance achieved. In this regard, we consider the [European SRI Transparency Code](#) (managed by EUROSIF) as a useful framework to help managers decide what they could disclose.

Q6: 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 are supportive of a high-level, principles-based approach to amending the guidelines. We agree that it is not necessary for all investment products to have a reference, hence the need for the inclusion of 'where relevant' in the relevant paragraphs. Whilst we understand the rationale behind in which instances to reference the consideration/inclusion of ESG in the investment strategy and when this is not necessary, it may be that the wording of 'ESG positive products' or 'non ESG products' is not the most appropriate. Given most managers will be formally incorporating some level of ESG factors into their analysis going forward, it may be more useful to make a distinction between those products which are:

- 'ESG orientated' e.g. ethical/sustainability/responsible considerations that are proactively/explicitly/formally part of the investment objective and strategy, and such factors act as the primary driver for inclusion of an issuer in the strategy.
- 'ESG integrated' e.g. ESG factors are proactively/explicitly/formally part of the investment process, but the focus is on those which are considered investment material. Where this is not the case, the strategy does not have to take the ESG factor into account.
- Others, which do not have to be referenced, would be those strategies where there is no proactive/explicit/formal consideration of ESG factors within the investment process.

Q7: 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.

We are supportive of a high-level, principles-based approach to amending the guidelines. We agree that it is not necessary for all investment products to have a reference, hence the need for the inclusion of ‘where relevant’ in the relevant paragraphs. The inclusion of a case study is potentially helpful in providing clarification on the application of the revised guidelines.

Q8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.

Whilst we support the need for transparency regarding the different ESG investment strategies that exist in the market to inform investor decisions, any resulting taxonomy needs to be inclusive to reflect the spectrum of different approaches, and avoid being prescriptive given how nascent and dynamic the ESG investing field is. We would support the emphasis on referencing where ESG factors are being incorporated into investment strategies.

To facilitate the matching of a client’s ESG preferences (if they have any, and if so, the emphasis they place on this), with an appropriate product, we believe transparency regarding the range of specific ESG investment strategies employed, and the extent to which they are a core or secondary driver of the strategy is helpful, as well as an indication about the range of E, S and/or G issues of primary consideration (and potentially give examples of what they consider to qualify under these pillar areas). On the former, at BlueBay we use the below graphic to illustrate the range of ESG investment strategies applied using ticks, which vary in size to denote the extent to which they are implemented:

The ESG investment strategies we employ 

ESG INVESTMENT STRATEGIES / BLUEBAY INVESTMENT STRATEGIES

	 ESG integration	 ESG engagement	 Ethical (negative/exclusions) screening	 Norms-based screening	 ESG tilting	 ESG best in class	 ESG (positive/thematic) investing ³
Pooled funds – ex Global High Yield ESG Bond Fund / Global Income Fund ¹	✓	✓	✓				
Pooled fund - Global High Yield ESG Bond Fund	✓	✓	✓	✓			
Pooled fund – Global Income Fund	✓	✓	✓		✓		
Segregated accounts	✓	✓	✓ ²				

Notes: ¹ This refers to the BlueBay Luxembourg, Cayman Island, and Dublin domiciled funds; ² This is a discretionary service available for clients where this is requested; ³ For example; climate change investing, social impact investing, microfinance, green bonds.

Q9: 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.

Transparency is key to ensuring clarity regarding the range and / or emphasis on E, S and G factors in an investment strategy. This could be approached in a number of ways, including:

- Naming of the product e.g. for products which take E, S and G factors into account, the fund name could include 'ESG' or 'sustainability' e.g. in February 2017, BlueBay launched our Global High Yield ESG Bond Fund, this has 'ESG' in the title to refer to the fact we take all these factors into account, although in practice, it is important to note some E, S of G factors / sub factors may be more material than others depending on an issuer's business activity and geography. A product which only focuses on environmental or a specific environmental factor could have this in its name e.g. X Environmental Fund, or Y Water Fund.
- Explicitly state within the description of the strategy, which E, S and/or G factor(s) is/are the primary focus e.g. a fund which primarily screens issuers based on their diversity or gender practices.
- As part of the client fact find, clients could be asked to complete a questionnaire which seeks to identify which E, S and/or issues they are most concerned about and want to see incorporated into their investment decision. Advisers can subsequently review what products exist in the market that best match the clients financial and ESG needs, and share these to explore the most appropriate route to take before making a decision.

Q10: 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.

Our answer here would be in line with the response we provided for Q5.

Q11: 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 information from clients and (b) the assessment of ESG preferences with the assessment of suitability?

We are supportive of the idea of collecting information on a client's ESG preferences, and the need to ensure this provides sufficient information to assess suitability of investments. However, at this stage it may be not appropriate to link this explicitly to the EU's classification of ESG investment products (i.e. the taxonomy), given the initial focus is on environmental products and as the final results are not yet available due to it still being in development. Rather, it would be more appropriate to reference the need to take into account current market standards especially given how dynamic the field of ESG investing is. If the EU taxonomy is to be explicitly referenced, we would suggest this is listed more as an example of something to consider rather than being prescriptive about this.

In determining what information could be useful to collect and a potential process to follow, the below guidance is one example of what may be useful to consider:



The process above is intended to help advisers offer guidance on green and ethical funds more effectively. Source: <https://www.sriservices.co.uk/advising-on-sri/sri-advice-roadmap>

Q12: 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.

Our answer here would be in line with the response we provided for Q9.

Q13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

We are supportive of the inclusion of ESG considerations where relevant to this paragraph. However, the proportionality principle should be kept in mind with regards to the adoption of robust and objective procedures, methodologies and tools, particularly given how nascent the ESG investing field is, and the data and knowledge challenges that still exist.

Q14: 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

It is difficult to generalise on this as the answer will vary from manager to manager depending on their unique situation and circumstances (i.e. size, nature, scope and complexity of manager's activities and the investment strategies they employ). We are not able to provide a detailed breakdown of BlueBay's financial resourcing as we do not disaggregate this; however, we have provided an overview below.

Information requested	Firm response
Firm size (annual turnover)	US\$60.1 billion (31 st Dec 2018)
Number of employees	Approx. 378 employees and partners in offices in the UK, US, Japan, Luxembourg, Switzerland, Germany and Australia (as of 31 st Dec 2018)
Firm complexity	We are a specialist fixed income manager, managing both private and public debt (corporates and sovereigns) in long only, total and absolute return strategies (spanning investment grade, leveraged finance, emerging market, convertibles debt, multi-asset and private debt)
Expected costs for market research related to ESG factors	<ul style="list-style-type: none"> • Difficult to isolate the full amount as other research resources may also encompass ESG factors even where it is not the primary focus for the subscriptions (also we do not track and monitor this explicitly) • As the nature of the ESG related funds have evolved, our costs associated with market research has increased • Overall, costs associated with market research of ESG factors can be financially meaningful
Expected IT costs related to ESG factors	<ul style="list-style-type: none"> • Difficult to isolate the full amount as it is included within broader IT projects where ESG factors are incorporated alongside others (also we do not track and monitor this explicitly). Costs associated with IT also tend to fluctuate to some extent over time depending on priorities • As the nature of how we seek to leverage ESG data has evolved, this has increased • Overall, costs associated with IT activities related to ESG factors can be financially meaningful
Expected training costs related to ESG factors	<ul style="list-style-type: none"> • Difficult to isolate the full amount, as we do not track and monitor this explicitly. Costs associated with training also tend to fluctuate to some extent over time depending on priorities • As the nature of how we seek to incorporate ESG into our investment processes has evolved, this amount has increased • Overall, costs associated with training can be financially meaningful
Other expected organisational costs related to ESG factors	<p>e.g.</p> <ul style="list-style-type: none"> • ESG dedicated staff (e.g. we currently have a team of four, having started with one person in 2013) • Cost of ESG related industry memberships • Cost for producing / maintaining ESG public reporting (e.g. annual ESG reports) <p>Overall these can be financially meaningful.</p>