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Sustainability becomes part of investment advice

ESG – Mandatory or optional?

Querying sustainability preferences in investment advice becomes mandatory

The impact of global warming has never been so noticeable as it is today. This is not only the perception of many people, but also the result of the recently published World Climate Report of the Intergovernmental Panel on Climate Change.[1] In its latest report, the council warns that global warming will accelerate much faster than previously assumed. In order to counteract this enormous challenge in the long run, the European Union would like to subject the financial market, like other economic sectors, to the EU Green Deal.[2] This is because the European capital market is to play a fundamental role in combating climate change. The European Commission is working at full speed to create the right regulatory environment to promote the reallocation of capital in favor of climate targets.[3] With its help, the European Union aims to ensure the transition to a low-carbon, more sustainable and resource-efficient circular economy, while at the same time making the European economy more competitive, innovative and resilient.

According to the EU Commission's ideas, the European financial sector is to play a leading role in directing capital in the future. After the EU Disclosure Regulation (SFDR) came into force in March 2021, creating new transparency obligations for financial market participants and the respective financial products, such as investment funds, sustainability will finally be introduced into investment advice in summer 2022.[4] This is, at least, what the adaptation of the regulations for the European Financial Markets Directive MiFID II envisages.[5] The recently published MiFID II regulations in the Official Journal of the European Union will make it compulsory to ask about sustainability preferences as part of the suitability assessment when advising on securities throughout Europe from August **2nd, 2022.**

Therefore, financial advisors must be prepared to ask their clients about their individual sustainability preferences in addition to their risk preferences and their personal investment horizon, and they must be prepared to take these into account when assessing the suitability of a product. In order to meet the investment preferences of their clients, financial advisors should first assess the investor's general investment objectives, time horizon and individual circumstances before addressing the potential sustainability preferences of their clients. Sustainability preferences in this context refer to a potential client's decision on whether and to what extent sustainable financial instruments, such as investment funds, should be considered as part of the investment decision. The only exceptions to this obligation are investment funds that are offered as part of the consultation free or execution-only business.

For a long time, the financial industry assumed that the European legislator would base the sales regulations relating to financial products on the definitions and product categories already in place, as defined by the Disclosure Regulation. But unfortunately, the definition of sustainability preferences follows a new and quite unique logic.
While the Disclosure Regulation does not make any statement about the design of financial products, such as investment funds, the legislator wants to ensure that investment funds recommended in the advisory service fit to the sustainability preferences of the investors.

[1] IPCC-Report 2021 – (IPCC: Intergovernmental Panel on Climate Change)
[2] Communication from the Commission, The European Green Deal COM (2019) 640 final, December 2019
[3] Communication from the Commission, Action Plan: Financing Sustainable Growth; March 2018
[4] DWS: Nachhaltigkeit erobert die Anlageberatung, Dezember 2020; https://www.dws.com/de-de/insights/investment-insights/nachhaltigkeit-erobert-die-anlageberatung/
[5] Commission Delegated Regulation (EU) 2021/1253 as of 21 April 2021

In the future, therefore, potential investors will be allowed to decide whether and, if so, to what extent any of the following criteria should be taken into account, when it comes to their investment decision:

Categories for sustainable investment funds[6]

1 | EU taxonomy
Financial instruments with a minimum proportion of environmentally sustainable investments as defined in the Taxonomy Regulation.[7] The minimum proportion of taxonomy compliant investments is to be determined by the (potential) investor.

2 | Sustainable investments
Financial instruments with a minimum share of sustainable investments as defined by the Disclosure Regulation.[8] The minimum proportion of sustainable investments is to be determined by the (potential) investor.

3 | Principal Adverse Impact (PAI)
Financial instruments that consider the most significant adverse impacts on sustainability factors. Qualitative and quantitative elements are to be determined by the (potential) investor.

In the future, the three categories mentioned above will not only be decisive for the design of investment funds but will also play an essential role in the investment advice. Hereafter, investors will have to be asked about their sustainability preferences in accordance with these three categories. If investors express sustainability preferences in this regard, these must be reflected accordingly in the investment strategy of the investment fund offered.

EU taxonomy

A lack of minimum standards and a lack of consistent frameworks have made it very difficult for investors to recognize whether their own portfolio pursues ecologically sustainable goals in the past. With the EU taxonomy, it should become easier for investors in the future to determine the minimum proportion of ecologically sustainable investments in their portfolios.
At the same time, the EU taxonomy aims to promote investments in favor of climate-friendly projects and companies. For this purpose, a cross-sectoral catalog of criteria for companies is used to define which economic activities contribute to achieve the EU's environmental goals.[9] These can be used to determine whether economic activities are environmentally sustainable.

Therefore, the following environmental objectives have been established:

- **Climate change mitigation**
- **Climate change adaptation**
- Sustainable use and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

The specific technical assessment criteria to help achieve the environmental goals of **climate change mitigation** and **climate change adaptation** were published in June 2021. The technical requirements for the missing four environmental goals will take some time to be published.
At this point, the EU taxonomy covers economic activities of about 40 percent of listed companies in sectors that account for nearly 80 percent of direct greenhouse gas emissions in Europe.[10] These sectors include, for example, energy, forestry and agriculture, manufacturing, transport and buildings.

Due to the current lack of transparency on the company side and the associated limited data availability for asset managers, but also due to still outstanding evaluation criteria, taxonomy-compliant investments will most likely initially represent only a very small share of sustainable investments in investment funds.

Sustainable investments

While the EU taxonomy currently focuses only on ecological aspects, the concept of sustainability as defined in the Disclosure Regulation is much broader. Thus, in addition to ecologically economic activities, investments that pursue a social goal also count as sustainable.

Examples of social factors

- ✓ Consideration of human rights
- ✓ Prohibition of child and forced labor
- ✓ Health and safety in the workplace
- ✓ Fair working conditions and appropriate remuneration

The United Nations Sustainable Development Goals or so-called SDGs are broadly defined and therefore well suited to

[6] Commission Delegated Regulation (EU) 2021/1253 as of 21 April 2021
[7] Investments according to article 2 (1) Regulation (EU) 2020/852 of the European Parliament and of the Council
[8] Investments according to article 2 (17) Regulation (EU) 2019/2088 of the European Parliament and of the Council
[9] Commission Delegated Regulation of 4.6.2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council
[10] European Commission – Press release, Sustainable Finance and EU Taxonomy: Commission takes further steps to channel money towards sustainable activities; April 2021

show investors the sustainability contribution of a company. For example, company revenues can be allocated as follows:

Basic Supply

Green Planet

Sustainable society

Equal opportunities

In the future, it will be important for advisors to know what the minimum proportion of sustainable investments in investment funds is in order to be able to assess whether the fund offered meets the corresponding sustainability preferences of investors.

Adverse sustainability impacts

Principal Adverse Impact (PAI) refers to the legislator's goal of either reducing or completely avoiding investments that significantly harm either environmental or social goals.

In order to show the adverse sustainability impacts, specific indicators have been defined in the latest Draft Disclosure Regulation, which are intended to make it possible to measure, consider and avoid negative environmental and social factors.

Sustainability indicators include, for example:

- Greenhouse gas emissions
- Energy intensity and efficiency
- Water consumption
- Percentage of environmentally harmful waste
- Social and employer issues
- Respect for human rights
- Biodiversity

For investment funds, it means ensuring that the indicators are considered as a binding element in the investment strategy.

There are different approaches to ensure that the principal adverse impact is considered. Company- or sector-specific exclusions, for example, can help to reduce adverse sustainability impacts in the portfolio. For example, potentially excluding companies that emit a lot of CO_2 or targeting investments in companies that produce less CO_2 compared to other companies can improve the relative carbon footprint of an investment fund.

Another way to consider adverse sustainability impacts and reduce them in the long term is through proxy voting, as well as corporate governance engagement. Both aim to accompany companies on their sustainability path through dialog and to represent the sustainability interests of fund investors with the help of active voting at annual general meetings. Regarding the adverse sustainability impacts, this allows specific CO_2 reduction targets, energy efficiency measures or employee concerns to be addressed in dialog with the respective companies and specific measures to be defined if necessary.

Another possible approach to consider adverse sustainability impacts is a best-in-class approach, specifically designed for this purpose. The idea is to exclude companies which, measured against the above sustainability indicators, not only have worse sustainability scores in absolute terms, but also in relative terms, than comparable companies in the respective sector.

German minimum standard on sustainability

In order to be able to offer investors the appropriate investment funds in the future, there is a need for consistent rules and comprehensible definitions of how funds can reflect the sustainability preferences of investors. The provided sales regulations outlined in the MiFID II regulations do not make any concrete statements on implementation in the respective investment strategies for investment funds. The challenge is therefore to implement the regulatory requirements in such a manner that investors ultimately understand how their own sustainability preferences can be considered in their investment decision.

A key building block here is a joint minimum standard of the German banking and asset management industry, with regards to the MiFID target market. This joint industry standard is currently being supplemented with a common understanding of sustainability and can be used in the future as a framework for the design, selection and distribution of sustainable investment funds in Germany. At the same time, this is intended to define uniform minimum requirements for sustainable investment funds.

The minimum standard thus created is intended to provide a certain degree of orientation and security for financial market participants, such as distributors, in Germany.

One thing is also clear: investment advisors cannot have any interest in marketing investment funds as sustainable if, for example, they invest in companies that commit serious violations of international human rights.

Challenges for advisors

In the future, investors will be allowed to decide whether they want sustainability aspects to be considered in their investments. **If sustainability preferences are expressed, the greatest challenge in the future will be to fulfill the investor's wishes with the help of the appropriate investment fund.**
In order to determine which funds, match the investor's individual sustainability needs, the advisor must decide whether and, if so, which of the three categories apply in terms of sustainability preferences. This will present investment advisors with the challenge of selecting investment funds that take into account not only the financial needs but also the corresponding sustainability preferences of the clients.

In view of a rapidly increasing number of "sustainable funds" on the market, it will be more important in the future to keep the different legal frameworks in mind. Of particular note when it comes to the product selection is the fact that the Disclosure Regulation and the MiFID II regulations **are not aligned with each other**. After all, there is no guarantee that investment funds that pursue an ESG strategy within the meaning of the Disclosure Regulation meet the sustainability preferences of the investor.

Finally, it may also be the case that the sustainability preferences of investors do not match with the product offering of the advisor. In this case, the legislator allows deviations. If investment advisors recommend investment funds that do not match the investor's sustainability preferences, they should explain to their clients or potential clients the reasons why they do not do so and document the relevant justification.

Conclusion

Almost 4 years after the publication of the EU Action Plan on Financing Sustainable Growth, sustainability is finally moving into investment advice as an integral part of the suitability test. With this, the European Union not only creates binding rules for financial advisors, but also underlines its ambitions in the fight against climate change and sets a clear signal for the reallocation of capital in favor of sustainable investments.

This shows very clear, it is time to act and put the current sales and business model to the test. After all, from August **2nd, 2022,** investors will decide whether and to what extent sustainability preferences should be included in their investment decision. By then, not only will the sales strategy have to be defined, the advisory process adapted, the IT programmed accordingly, and the staff trained, but also the appropriate investment fund will have to be on the shelf.
Some financial sales organizations have already started this exercise and are already actively inquiring the sustainability preferences of their clients.
This could be one reason for the high inflows into ESG funds in Germany over the last year. According to the report, **more than 22 billion Euros** flowed into sustainable mutual funds in Germany in the 1st half of 2021, which is more than in the entire year 2020: (20.6 billion euros).[11]
It can be assumed that the mandatory query of sustainability preferences in investment advice is likely to further fuel the already strong demand for sustainable investment funds in the coming years.
However, at this time it is not possible to estimate how sustainability preferences will be queried in practice and how investment funds will develop in this respect. Only by taking these developments into account financial advisors will be able to offer the right funds for their clients' sustainability preferences in the future.

Finally, it remains to be seen whether, with the help of the newly created sales regulations, the necessary capital can be shifted to ensure the transition of the European Union to a low-carbon, sustainable and resource-friendly circular economy and, at the same time, to make the European economy competitive, innovative and resilient. In the end it is still the investors decision to decide how and where to invest their money.

[11] BVI Statistics, as of June 2021

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Important notes