Environmental, Social and Governance (ESG) Investment, Sustainability and Advice Suitability Unwrapped

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> We are committed to seeing climate change and sustainability integrated into all financial transactions, not just dedicated sustainability-labelled securities and investments.

Nikhil Rathi, CEO FCA November 2021

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INTRODUCTION

The ongoing focus on **Environmental, Social and Governance (ESG)** investment highlights the financial services industry's ongoing instrumental role in the transition to net-zero, through its ability to mobilise capital and engage with investors, companies and citizens.

Yet there still seems to be a large amount of scepticism with investors themselves when engaging ESG investment products and strategies. In a **recent survey by the Association of Investment Companies (AIC)** whilst 65% of private investors said they would consider ESG when investing, it is the least important factor when choosing an investment.

A reason for this would obviously be the fact that ESG has recently moved from niche to mainstream investment initially due to the **United Nations Principles for Responsible Investment (UNPRI)**. Yet given Responsible Investment can be traced back to the 1800's with religious groups such as Quackers and Methodists establishing socially responsible investing amongst their followers and the current climate emergency the world now faces, what this points to is a need for investor education.

The good news is Retail Investment Advice (RIA) firms are now engaging ESG. **NextWealth's excellent Financial Adviser Benchmark Report** '21 showcased that 21% of client assets are invested in ESG, ethical, sustainable of impact funds or portfolios which is nearly double the previous year. Client interest is also building with ESG and impact investing coming up in a fifth of client conversations and the majority of RIAs make use of ESG funds or portfolios.

With industry and business interest in ESG strategy, policies and procedures growing, this means that clients will gain confidence and social proof in the benefits for ESG investing.

In reaction to **Europe's Sustainable Finance Disclosure Regulation (SDFR)** we also have the **latest FCA strategy and discussion paper** to consider with The FCA introducing its own Sustainability Disclosure Requirements for firms involved in investment management and decision-making processes. Plus plans to classify sustainable investments into distinct groups may also be aligned with existing SDFR categories.

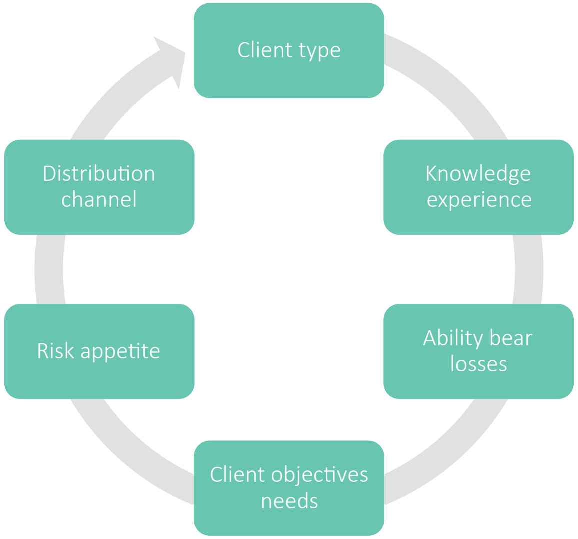
With a focus on sustainable investment labels and consumer disclosure requirements plus the need to combat greenwashing, we also have a need for acknowledging the role for PROD and client segmentation. This, with the new **FCA Consumer Duty**, effectively brings the need for a fiducial duty for RIAs and product manufacturers to ensure products are distributed appropriately to meet advice suitability requirements.

This means that RIAs need to make a clear distinction between direct to consumer (D2C) investors and personal investors who require blended, and risk rated portfolios, something surprisingly missed from the latest FCA directives.

When it comes to business management, ESG is also a strategy worth considering particularly with the **COP26** conference pushing the climate emergency action to another level.

All this along with the **all-new consumer duty** means that wealth advice firms need to ensure they take a new look at their advice suitability processes and strategy to ensure it is extended to include ESG assessment, ascertains an investor's sustainability requirements and incorporate them in portfolio recommendations. This guide looks at strategies firms might want to consider when adding ESG into the advice process.

THE TARGET MARKET



A good place to start is the product governance rules **PROD 3.3**, which focuses on product manufacturers included end client needs and requirements in product design, and distributed to the right clients. This is reflected in the right diagrams key points;

- **Client Type:** Retail, Professional, Eligible Counterparty
- **Knowledge & Experience:** Basic, informed or experienced investor
- **Ability to bear losses:** The amount of loss an investor can tolerate
- **Client needs and objectives:** Timeframes across product holding periods
- **Risk:** Synthetic Risk and Reward Indicators, Attitude to Risk and Capacity for Loss
- **Distribution channel:** Retail and/or Professional

Retail Investment advisers will need to ensure their services and recommended products are allocated to the right clients based on their needs, preferences and ESG understanding. So a segmentation strategy including research and due diligence is crucial in allocating the most appropriate products to the stage of wealth planning journey the client is on.

Table 1 below, provides an example for segmentation of a client bank. What is important is for a firm to move away from just focusing on demographics and tangible assets. This means including client's behaviours, their investment stage of the journey and preferences and sensitivities when it comes to key issues such as sustainability, service and product price and features and benefits.

Table 1: Example client segmentation strategy

Segment	Sub-Segment	Investment Solution	Platform Selection	Advisory Service	Cost £	
					Initial	PA
Young Accumulators	Job starters	Savings acc, LISA	Simple low cost	Light Touch, Tech, Sustainability		
	Young Execs	ISA	DFM	Standard, Tech, Sustainability		
Runway to Retirement	Employed	DC, Auto Enrolment	CIP/Model Portfolio	Standard, Advanced. Sustainability		
	Self-Employed	PPP	Discretionary	Light/Standard Sustainability		
Retirement Income	Low/No Income	CRP	CIP	Standard, Sustainability		
	High Income	Growth	Invest/Annuity	Cashflow/Bespoke, Sustainability		
Vulnerable	Mental Physical	Protected	Invest/Withdrawal	Tailored Sustainability		

What is clear is that RIA firms need to ensure they place their client's needs front and centre of their services which involves a 'double lock' arrangement for providing **suitable** advice and advising **appropriate** products to meet their client's on-going needs and objectives. This double-lock arrangement is important given the European Securities and Markets Authority (ESMA) published a **consultation paper** on **27th January 2022** which updates the **November 2018 guidelines on aspects of the MIFID II suitability requirements** on new suitability rules.

With a view on tighter control for consumer protection this chimes with the FCA agenda and thus it is almost certain the FCA will follow. The amendments propose a number for changes:

Table 2: ESMA proposed advice suitability changes

Information to client about the purpose of the suitability assessment and scope	Firms should help clients understand the concept of 'sustainability preferences'
Arrangements to understand clients	New requirements to collect information on client's sustainability preferences
Updating clients sustainability information	First meeting post new suitability rules introduction 2nd August 2022
Arrangements to ensure the understanding investment products	Importance for understanding the characteristics, nature and features of investment products against the sustainability factors of investment products
Arrangements to ensure the suitability of an investment	Assessed against the clients knowledge and experience, financial situation, objectives and sustainability preferences, Client may adapt sustainability preferences in certain circumstances (product does not meet initial sustainability preferences) but this needs documenting and restricted to the one assessment, and recognise limited availability of sustainability features i.e. young market, finally address where a client does not provide sustainability preferences
Costs and benefits of switching	Need to be clear and understood by the client, gaining the client's informed consent
Qualifications of staff	Necessary knowledge and competence regarding sustainability preferences, ability to explain to the client in non-technical terms
Record keeping	Keep client records of sustainability preferences

ADVICE SUITABILITY CHALLENGES

With the above mentioned new MIFID II suitability rules coming through this year, RIAs will benefit from having a clear in-house ESG strategy which will keep them ahead of their competitors and redux any complexity and reduce the risk of client preferences being adversely affected. There are several areas to consider:

1. **Terminology:** Clear client communications across ESG

2. **Disclosure:** Ensuring that products have clear and not misleading language on features, benefits, costs and risks and any ESG data limitations and how this corresponds to categorisations and performance scenarios

3. **Client preferences:** Extending the suitability process to obtain client preferences at a granular level across each ESG component

4. **Sustainability:** Ensuring the right products are chosen to meet on-going client and regulatory needs

5. **Performance:** Providing a credible range of performance scenarios for client's ESG investments

6. **Risk:** Ensuring investments and advice are suitable so that ESG preferences are combined with liquidity, expenditure and risk profile plus reducing regulatory risk such as greenwashing by having well recorded and documented;
   a. Research for determining ESG classifications, risk management policies
   b. Governance challenge and oversight
   c. ESG client conversations and suitability assessments

7. **Conflicts of interest:** Ensure clients are aware if ESG strategy conflicts with their existing profiles

8. **Comprehensive understanding:** A client's preferred ESG strategy across whether they prefer divestment from non ESG compliant stocks or actively invest in certain ESG compliant stocks and whether they prefer investing in non-compliant stocks that invest in sustainable operations

9. **Consistency:** Across internal categorisation and external marketing of ESG products and suitability assessments

THE NEW SUITABILITY RULES

The existing MIFID II advice suitability rules adopted by the FCA **COBS 9A.2.1R** focus on gaining the client's knowledge and experience, ability to bear losses and objectives including risk tolerances. With the European Commission pushing to include client's sustainability preferences in the suitability process, the UK looks like it will follow suit with City Minister John Glen stipulating the UK will 'at least match the ambition of the EU sustainable finance plan'.

So UK based retail wealth advice and management firms should (at the very least) now be aware of how sustainability effects client's investments and familiarise themselves with the new rules and any operational changes required.

As per table 2 the new rules will mean firms have to:

1. Explain how sustainability factors are considered
2. Consider client's sustainability preferences
3. Obtain relevant information on client's objectives including sustainability
4. Devise research and due diligence methodology to ascertain sustainability in selection of investments for clients
5. Include sustainability preferences and how investments meet them in a client suitability report
6. Systems and controls to avoid mis selling or misrepresentation of sustainable investments such as ensuring a client's objectives, time frames and circumstances are gained prior to gaining sustainability preferences
7. Ensure compliance teams understand the new sustainability concept and definitions and how they are applied to firms advice suitability processes. This also includes defining sustainability preferences as to whether the following are included in a firms investment distribution strategy;
   a. Investment products that have sustainable investment as their objectives
   b. Products that promote environmental or social characteristics in relation to Article 8 of the Sustainable Finance Disclosures Regulation, pursue sustainable investments (as Article 2) and (as of 30 December 2022 and Article 7) consider principle adverse impacts on sustainability factors

ESG, ADVICE SUITABILITY AND DISCLOSURE

The FCA published their **Discussion paper DP21/4** to seek industry views on new sustainability disclosure requirements. The City watchdog suggests that the sustainability disclosures (SD) be split into three areas will include the following:

1. Consumer facing disclosures:

- the product label
- the objective of the product, including any specific sustainability objectives
- the investment strategy
- the proportion of assets allocated to sustainable investment (as defined by the UK Taxonomy)
- a firm's approach to investor stewardship
- wider sustainability performance metrics

2. Product level disclosures:

- information on how metrics have been calculated
- information on data sources, limitations and quality
- supporting narrative and contextual and historical information
- information about UK Taxonomy alignment
- information about benchmarking and performance

3. Detailed disclosure:

- Made at entity or product level
- More granular and additional information

The FCA is proposing a labelling regime that will provide better disclosure and help consumers and institutional investors make more informed decisions. These disclosure proposals are ambitious and far reaching and will require impact assessments, categorisation and plenty of updates to disclosures.

PLANNING YOUR ADVICE SUITABILITY APPROACH TO ESG AND SUSTAINABILITY

With the need to expand suitability assessment to ascertain investor's sustainability preferences and incorporate them into portfolio recommendations wealth advice firms need to devise a strategy and systems and controls across their advice practices. Here are some points they may wish to consider:

Decide on ESG investment service capabilities and scope, whether this includes sustainable investing and/or using 'green' investment components.

Construct a research and due diligence process that incorporates sustainability. The FCA's Assessing Suitability Thematic Review, TR16/1 is a good resource here which focussed on firms creating a culture for challenge to ensure conflicts of interest, biases (such as status quo) were identified and managed and having robust systems and controls assessing reasons for recommendations and combat any risk of greenwashing within recommended portfolios.

Educate the investment and advise team on ESG, the regulatory approach and impact of disclosures on the advice process.

Explaining the ESG and sustainability proposition clearly to clients is essential (remember your clients will have a different view on what ESG means!) and gain informed consent and manage expectations.

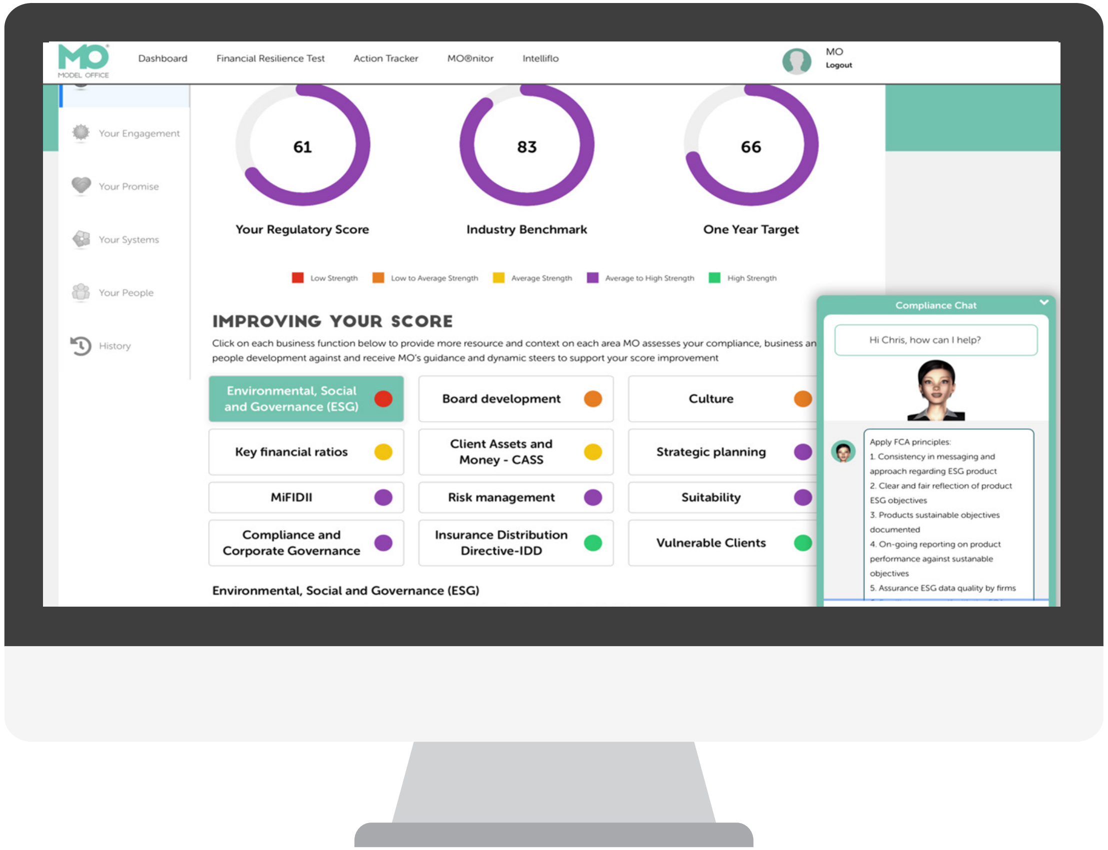
Fact finding techniques need to gain a comprehensive understanding for client's attitude to risk and matching client's preferences with suitable investments and sustainability.

Collate data on portfolio sustainable strategies and segment investment products based on your client needs.

Ongoing analysis to ensure the suitability process is monitored over time and in line with the very latest regulatory directives.

HOW REGTECH CAN HELP

Model Office-MO® provides firms with a governance, risk and compliance hub, where all relevant regulations can be assessed, audited and benchmarked by the compliance team in one place. MO®s diagnostic questions and algorithms will provide heat mapped dashboards detailing where firms believe they are against the regulations. MO® has now included an ESG business function within its Your Focus key, so firms can begin to self-audit themselves against the regulatory directives detailed in this report.



Firms need to gain a third line of defence and self-audit on a regular basis, due to the continuing 'regulatory rain'. This means they can prove the comply or showcase they are acting on any areas they need to address and improve saving time and costs along the way.

The below image provides a view on how MO® can help support firms develop sound ESG operations and compliant advice propositions.

The RegTech platforms heat mapped dashboards provide dynamic steers and resources providing valuable information on where a firm should focus to improve their scores and an action tracker which then provides real-time action planning and compliance calendar alerts along with a documentation system where evidence can be recorded on accountabilities, responsibilities and action taken.

The system will provide alerts and a chat bot for firms to ensure they engage, stay on track and evidence actions.

SUMMARY

As can be seen there are several challenges to be met when addressing advice suitability processes and client ESG and sustainability preferences. Firms need to ensure they have their own house in order which means adapting systems and controls, advice and product offerings. The consumer duty must also be incorporated in acting in the best interests of clients and meeting the cross-cutting rules;

1. Take reasonable steps to avoid foreseeable harm
2. Take reasonable steps to enable consumers to pursue their financial objectives
3. Act in good faith

This means that firms need to up their game on advice suitability and ensure their products and services, including ESG, are fit for purpose, represent fair value, do not exploit client biases such as inertia or vulnerabilities.

Fact finding will no doubt need to be expanded and firms may want to consider designing and adopting a separate ESG, sustainability focused fact find ensure risks such as greenwashing and client’s understanding for ESG and sustainability are managed. Plus any conflicts are identified with client needs and preferences and sustainability.

With disclosure in mind, performance scenarios need to ensure accurate data, fund information and taxonomy is clear, understandable and meet regulatory requirements. Risk-assessment including capacity to loss is included and assessed against appropriate synthetic risk and reward indicators (SRRI) and Key Investor Information Document (KIID). This should also include costs and charges for switching and replacement business disclosure rules.

Segmentation will become a key tool across matching suitability and appropriateness for ESG and sustainable investment products to client needs and preferences.

As regulatory competence and conduct moves towards a world of increased accountability and responsibility for ESG and sustainability, adaptation of advice suitability strategy now needs to be front and centre for firms to continue to expand their services to incorporate client demands and preferences.

To learn more on how Model Office-MO® can help, contact us on info@model-office.co.uk

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