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DEVELOPMENT PLATFORM

SUITABILITY & SUSTAINABILITY

In association with

BMO Global Asset Management

AEGON

PICTET Asset Management

Guide edited by **John Lappin**, leading industry commentator

Sponsors

At **BMO Global Asset Management**, we have always believed that responsible investing is just good investing. Over 35 years ago, we launched Europe's first ethically screened fund, and ever since, we have been building our capability and launching innovative funds and solutions for clients. To us, investing responsibly is not simply a box ticking exercise. It is our belief that being a responsible investor is key to reducing risk and improving outcomes over the long term – making a positive difference to our clients and the world. We use our investor voice to influence not just companies but governments and regulators too, to establish appropriate policies on environmental, social and governance issues. We regularly share insights on issues from plastic in the oceans to living wages for developing nations. We can help build an understanding of these challenges and the ways that responsible investment is providing solutions to them. Our range covers themes and priorities across asset classes and regions, multi-asset solutions and reo®, our Responsible Engagement Overlay Service.

Learn more about our portfolio

Find out more through our insightful research

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As investment providers and a responsible business, we have a large part to play in the fight against climate change. We believe that it's not just an environmental issue, but one that is central to the future financial wellbeing of our customers. By taking a responsible approach to considering environmental, social and governance (ESG) issues in our investment process, we reduce societal and environmental risks and explore new opportunities to serve our customers' interests and those of society.

Continue

At Aegon, we continue to enhance our approach to ESG. In 2020 we published our responsible investment framework, which sets out our approach to ESG and a minimum standard for fund managers to adhere to. We have recently embedded ESG in our default funds, with a commitment to net zero carbon emissions across our default funds by 2050. And we have exciting ESG platform and investment proposition developments for the year ahead.

To find out more about our investment proposition

PICTET Asset Management

Pictet Asset Management: our approach to responsible investment

Responsibility is embedded in everything we do, starting with our investment framework.

Responsibility goes hand-in-hand with a long-term, partnership approach. It means having a sense of responsibility and integrity not only towards the present generation but also to future generations – and to the real economy and the wider world.

We believe in responsible capitalism and take an enlarged view of the economy and its interactions with civil society and the natural environment.

We are convinced that Environmental, Social and Governance (ESG) considerations can help us make better long-term investment decisions for our clients.

The strength of our convictions led us to create for our clients a range of innovative environmental and social equity strategies such as Water (our first environmental strategy launched in 2000), Clean Energy, Nutrition and Global Environmental Opportunities.

Find out more

For more info

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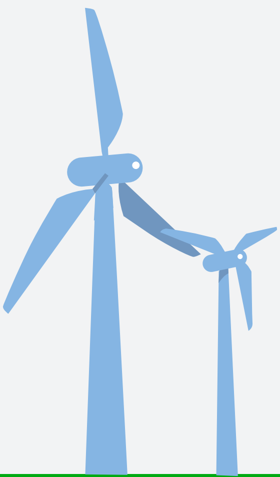


Section 1
The background picture

The issue of sustainability has risen up the agenda dramatically for financial advisers in recent years.

Under the broad headings of sustainability, environmental and social governance (ESG) and impact investing, there are significant shifts occurring in stock and bond markets and with the regulations governing investment and pension funds. Regulatory requirements will also soon affect advisers directly as well.

Yet, the picture can be confusing partly because there is no one regulation, law or initiative that encompasses the topic.

Some change is being driven by businesses themselves, some by consumer behaviour and some enabled by technology.

Yet among the biggest changes for now – are those driven by governments setting targets, creating standards, issuing green bonds using sustainability criteria and setting out new rules for businesses. These are then generally refined and interpreted by regulators, especially financial regulators, although as you can see later, Brexit has complicated things.

This guide will set out to help advisers navigate this landscape while identifying those regulations of most importance and indeed where decisions are still to be made.

It will also suggest some important and significant points for advisers to consider in terms of clients and the shape of their businesses.

Section 2

Key developments and statistics

Responsible investment sees huge UK inflows

Investment Association fund statistics published in November showed that responsible investment funds saw net flows of **£7.1 billion** in the nine months up to September 2020 - nearly four times the £1.9 billion seen for the same period over 2019.

FTAdviser

ESG funds could be the majority in Europe by mid-decade

Consultancy PwC recently forecast that in Europe **between €5.5 trillion and €7.6 trillion** could be invested in ESG funds by 2025 or between 41 and 57 per cent.

2022 the growth opportunity of the century – are you ready for ESG change.

Impact investing becoming clearly established globally

The impact investing market was estimated at **US$715bn** in 2019 in a report published last year by the Global Impact Investment Network.

Global Impact Investment Network

Continue

Climate bond issuance approaching $1 trillion

Bonds intended to finance climate transition saw issuance in September 2020 of **$32.2bn**, taking cumulative figure since the inception of green bonds to USD948bn, getting closer to the $1trillion milestone in the Climate Bonds Database. The figure translates into 12% year on-year growth compared with September 2019.

UK Stewardship embraces ESG

The Financial Reporting Council updated the Stewardship Code for institutional investors in October 2019 to include ESG. It came into force on 1st January 2020.

It defines stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

Principle 7 requires signatories to "*systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities*".

frc.org.uk

The UK launches a green finance plan

Launched in July 2019, the plan aims to align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by Government action. To strengthen the competitiveness of the UK financial sector. It is linked to other initiatives including the **Clean Growth Strategy**, **25 Year Environment Plan** and **Industrial Strategy**.

Green finance strategy - GOV.UK

Continue

UK sets in train rules requiring big investors, pension funds and companies to disclose climate risks

In November 2020, the Treasury published a cross-Whitehall/cross-regulator taskforce **'roadmap'** charting a path towards mandatory disclosure regarding climate change for large sections of the economy over the next five years. It will eventually encompass large listed and private firms, pension funds, asset managers and banks and building societies.

Those requirements were set out by the Taskforce on Climate-related Financial Disclosures and kick in between now and 2025 starting with the larger concerns first. For some of the measures, the institutions will have to show how they are complying or explain why they are not.

Treasury roadmap

Regulations for UK premium-listed companies already in force

As part of the initiative above, the FCA published a **policy statement** and final rules and guidance promoting better climate-related financial disclosures for UK premium listed companies in November. Companies will be required to include a statement in their annual financial report which sets out whether their disclosures are consistent with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) and to explain if they are not – a 'comply or explain' approach. The rule applies for accounting periods beginning on or after 1 January 2021, meaning the first annual financial reports published under the new rules would then be published in spring 2022.

FCA document

Continue

China finally sets a date for going carbon neutral

There is a very long way to go but China has pledged that CO_2 emissions will peak in 2030 and that it will be **carbon-neutral by 2060** with President Xi Jinping making the pledge in a speech to the UN Assembly in September 2020.

'Enhance solidarity' to fight COVID-19, Chinese President urges, also pledges carbon neutrality by 2060

Biden signals a big shift including signing up to the Paris climate goals

President Biden has a plan for the U.S. to achieve a **100% clean energy economy** and reach net-zero emissions no later than 2050 with huge investments in renewable energy including electric transport and clean tech. The President signed back up to Paris as one of his first acts.

Plan for Climate Change and Environmental Justice I Joe Biden

Paris Climate Agreement I The White House

Global, EU and UK sustainable finance initiatives I Global law firm I Norton Rose Fulbright

Continue

UK to ban sales of petrol and diesel cars

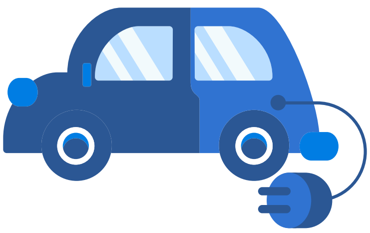
The UK is to **ban sales of petrol and diesel cars** by 2030 while vehicles that can complete at least part of their journey with zero emissions, such as hybrid or plug-in cars, will be allowed to be sold until 2035 as part of a policy announced by the Prime Minister Boris Johnson in November 2020.

UK to ban sales of petrol and diesel cars by 2030 in zero emissions bid

UK renewable energy above 40 per cent of total

Electricity generation from coal was **down nearly 30 per cent** on the same period last year and now comprises just 0.7 per cent of total generation in the UK. Despite a relatively small increase in renewable capacity year-on-year, renewable generation is up to 40.2 per cent of total generation, a significant increase on the 8.2 per cent in the same quarter 10 years ago.

UK energy trends survey July to September 2020



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EU in front in terms of sustainability and ESG with a range of interweaving initiatives.

The EU is widely regarded as setting the pace in terms of ESG and sustainability but as you can see below, it is rather a complicated process.

On 7th March 2018, the EU launched the transition to a low-carbon, more resource-efficient and sustainable economy by launching a dedicated **action plan on sustainable finance** which aims to re-orientate finance towards sustainability.

It had three **goals**:

- to reorient capital flows towards sustainable investment, to achieve sustainable and inclusive growth.
- to manage financial risks stemming from climate change, environmental degradation and social issues.
- to foster transparency and long-termism in financial and economic activity.

Key actions included:

- establishing an **EU classification system** – or taxonomy – for sustainable activities.
- establishing **EU labels** for green financial products.
- increasing the transparency of companies on their **environmental, social and governance (ESG)** policies.
- a **proposal for amending the benchmark regulation**, creating a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks.

On 11th December 2019, the Commission presented the **European Green Deal**, a growth strategy aiming to make Europe the first climate neutral continent by 2050. As part of the Green Deal, on 14 January 2020 the Commission presented the **European green deal investment plan**, aiming to mobilise at least €1 trillion of sustainable investments over the next decade.

It said this will enable a framework to facilitate public and private investments needed for the transition to a "*climate-neutral, green, competitive and inclusive economy*".

Section 3

Europe marks big shift in adviser responsibility

However, the key issue for advisers comes from the following.

In January 2018, a High Level Export Group reported to the Commission suggesting changes to requirements for asset managers and advisers. It suggested that investment advisers should be required to ask about, and then respond to, investors' preferences regarding the sustainable impact of their investments, as a routine component of financial advice.

Then as part of the Action Plan on Financing Sustainable Growth published a couple of months later, the Commission announced amendments to MiFID II and the Insurance Distribution Directive, with advisers required to ensure that clients' sustainability preferences were taken into account in the suitability assessment.

This would involve clarifying an investor's ESG preferences possibly by means of a questionnaire.

To quote the proposals, they were:

> *To enable investment firms that provide investment advice and portfolio management to recommend suitable products to their clients, those investment firms should introduce in their suitability assessment questions that help identify the client's individual ESG preferences.*

> *In accordance with their obligation to act in the best interests of the client, recommendations to clients should reflect both the financial objectives and, where relevant, the ESG preferences expressed by those clients.*

> *In order to avoid 'mismatches', investment firms providing investment advice should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences.*

> *Investment firms should also explain to their clients how their ESG preferences for each financial instrument are taken into consideration in the selection process used by those firms to recommend financial products.*

Continue

The rough equivalent to the FCA in the EU, the European Securities and Markets Authority (ESMA) was also asked to include provisions on sustainability preferences in its guidelines and issued a final report on this work in 2019.

We are still awaiting what are described as the 'revised delegated regulations, which are expected to be published in the Official Journal in March and which then gives firms a year to comply.

Commission delegated regulation amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management

High Level Expert Group Report

ESMA's final report to the Commission on the 30th April 2019

Simmons & Simmons summary of the complicated legislative process

Section 4

What should I be doing as a UK adviser?

There is not one easy answer yet, as there are no sets of rules or even a consultation to point to which directly applies in the UK, but it is likely this will come sooner rather than later and once again borrow from EU regulations.

Post transition, why has this anything to do with the EU?

To sum up the position for UK advisers and indeed the broader UK investment market, the immediate issue is when and whether the UK follows the EU in terms of the suitability and sustainability requirements.

Most of the MiFID directives still apply in the UK, predating the end of the transition at the turn of 2020/2021.

If the UK was still in the EU, single market or even in an extended transition, the regulations would apply to UK advisers from March 2021, though with a year to comply.

However, as the UK has left the regulatory structures of the FCA, this depends primarily on the UK government though it may also depend on developments in EU and UK relations.

The UK has left the EU with a slim deal mostly governing goods. Financial services are the subject of discussions. It remains unclear how much the UK might diverge and set an independent course. That applies not just to new regulations but amendments such as MiFID II.

In broad policy terms, the UK and EU are to publish a memorandum of understanding expected in March. For now, the UK has created a temporary regime for EU and European Economic Area firms operating in the UK. UK firms have lost their single market passport.

The EU has not yet to offer 'equivalence' which would see it largely recognise UK firms.

We can probably say that whatever arguments about market access, the UK and EU agendas appear to dovetail on sustainability.

Indeed, the practical issue may simply be the lack of regulatory time given the pandemic, other Brexit matters and the FCA's transformation programme which involves a significant reorganisation.

Section 5

What does the FCA say?

Adviser Home asked the FCA for its current view on sustainability and suitability. They said:

> *The Commission amendments to the suitability rules to take account of ESG change are a part of MiFID that is now in Treasury legislation rather than our Handbook. Therefore, a decision about amendments to those provisions in the UK currently rests with the Treasury.*
>
> *Both ourselves and the Treasury are committed to the same sort of goals as expressed in the EU's Sustainable Finance Action Plan from which these amendments stemmed. We remain supportive of making sure the financial services sector plays a role in sustainability.*
>
> *Amendments to the suitability rules to reflect sustainability concerns are therefore something which is likely to be looked at, but the timing of any policy proposals emerging from that consideration is not currently known. However, any changes to the UK rules in this area will be subject to normal policy procedures and therefore firms will have an opportunity to comment on changes and will be kept informed of relevant timetables.*

The regulator also drew our attention to a speech by chief executive **Nikhil Rathi** from November 2020 and we quote from it below.

> *This year we have seen record inflows into sustainable investment products and record issuance of social and sustainable bonds. According to Morningstar, flows into such funds in the third quarter exceeded 50 billion Euro for the second successive quarter. This represented 40 per cent of all European fund sales. At the same time, sustainable equity funds gathered 82% more new money than traditional equity funds.*
>
> *As this market grows, we want to ensure that consumers can trust sustainable products. To do this firms need to be clear on their obligations around the design, delivery and disclosure of sustainable products. And consumers should receive the right information and advice.*

Continue

FE fundinfo regulatory manager Mikkel Bates says:

Mikkel Bate

FE fundinfo regulatory manager

> *My understanding is that the FCA is planning for everything on ESG to be pretty consistent with the rest of Europe. I don't think anyone is holding out too much hope for the MoU to resolve everything/anything. With MiFID II embedded here and nobody wanting to be seen as soft on sustainability, there is likely to be a similar focus here. Also, fund groups will be looking for a high degree of consistency in what and how they need to report, whether that is for MiFID through the European MiFID Template and other templates or through fund reports. Many fund groups have matching funds for the UK and Europe now and will want the same obligations to apply to both.*

It therefore looks likely that it is only a question of when, not if.

Section 6
What should advisers and firms do now?

Our view and the view of most experts is that the reforms are definitely on the way, so advisers need to consider when the implications for their planning and processes.

But we have given some thought to what this means for UK advisers.

Currently, as is clear from the FCA statement, there is no start date to really concentrate minds.

The statement may also suggest a consultation process is likely.

If it borrowed directly from the EU, it would require an adjustment to the advice process but one that would come after client objectives, time horizon etc are established.

It is likely the FCA process will use the vocabulary of the UK advice processes rather than what is often a broad-brush approach designed for 28 (now 27 countries) which the Commission and ESMA can sometimes use.

We think it is unlikely that the regulator will require a mere box ticking exercise simply to include or exclude ESG considerations.

So, there is a strong case for saying that advisers should respond to market and consumer forces and reflect suitability attitudes in the suitability and client advisory process.

Is this for new clients alone?

We'd expect that advisers would wish to move towards consistency between new and existing clients and regular reviews would seem to present an opportunity for advisers to incorporate a sustainability conversation.

ESG/sustainability reflecting client preferences

Of course, once clients express an attitude or preference, advisers need to consider how to reflect those preferences.

If the client has clear attitudes requiring an investment or their overall plan to reflect non-financial goals then this must be explicit in the documented advice.

Continue

ESG/sustainability reflecting client preferences

We are seeing huge movement in terms of asset managers and discretionary fund managers embracing a host of fully sustainable approaches, ESG integration and services which can be integrated into advisers' investment processes and portfolios. There may be choices to be made as to whether advisers offer an option or in the case of ESG integration apply that across their portfolios. This would not be a deep green approach but incorporate many recent developments across asset management.

It could also make sense to assess how much ESG is already intrinsic to your recommendations as many asset managers are using ESG across their other teams.

For example, managers now regard ESG, particularly the governance element, as helping manage risk. The same applies to an extent to sustainability though that may depend on your assessment of how much climate risk is contained in indices and thus portfolios.

It is also notable that the Bank of England will in 2021 make climate change risk exposure part of the Prudential Regulatory Authority's stress-testing for banks and insurers.

> “ *In 2021, building on the 2019 Insurance Stress Test, the Bank of England will also stress test the largest banks and insurers to the financial risks from climate change that could arise in a variety of different climate scenarios.*

What questions should advisers be asking?

This is the subject of a lot of debate with a range of suggestions from providers and advisers, particularly those who have already fully embraced the concept so we look at those below.

These are reasonable suggestions from Royal London as to what might be included in a fact find across the spread of ESG factors.

- How strongly do you feel about environmental factors such as climate change, and a company's environmental footprint and activities?
- How strongly do you feel about issues involving corporate governance?
- What about social issues such as diversity, equal opportunities and working conditions?
- How important is it to you to invest in companies that take environmental, social and governance - or 'ESG' factors - into account?
- Are there any particular sectors or industries you'd wish to avoid, even if meant you would potentially earn less on your investment?

Continue

Individual adviser firms will be debating how to formalise the questions. It may be led by the regulator if, as it says in its statement, there is a consultation process.

Firms will want something that works for their advisers, can be understood by clients and meets the regulations.

It’s important that advisers establish with clients the balance between strict financial objectives and sustainability priorities. Whilst in some conditions there may be no conflict between the two sorts of goal – in other market conditions there maybe. Advisers will want to be confident that client attitudes to potential ”trade – offs” are clear and well documented.

We look forward to seeing what the EU publishes finally as the ‘sustainability’ discussion is currently envisaged coming between the process of establishing client objectives and implementation. You might question whether that is sufficiently integrated into the process and whether the FCA might provide more clarity.

We see some other developing issues, however. For example, advisers who have started to incorporated sustainability questions tell us that it is relatively easy to access solutions for clients with broad concerns, but it is more challenging if they have specific concerns.

It is also interesting to see how one adviser firm which has embraced sustainable investing and related advice approaches the issues such as where sustainability comes in during the process and indeed how detailed client concerns are.

Alan Chan, director and chartered financial planner with IFS Wealth and Pensions says:

> “ *We typically discuss responsible investing during our onboarding process with clients. As you can imagine during the onboarding process, there are a lot of things we discuss with the client, mainly high level stuff about their life goals, objectives, current assets, concerns etc. and so responsible investing would normally be a small part of the initial conversation.*
>
> *At this stage we’re just trying to get a feel for where the client is at with it and if they hold strong views.*

“

We try not to lead the client down the road of telling us which companies they dislike and want to omit because this is a dangerous path to go down. We cannot guarantee that the portfolios does not have, nor will ever have a certain holding and it could be damaging to the returns over the longer term if certain sectors are omitted completely. It's much of an educational process to begin with to explain what responsible investing involves and the nuances to it, such as ethical, sustainable, ESG, and impact investing.

Should the client hold strong views on certain types of investments or companies and do not want any money invested there, we would then see if it's feasible to either build a bespoke portfolio for them that we manage in-house or delegate the investment management to a DFM instead to better suit the client's investment preferences. However, most clients will understand that it is not a perfect world, companies are not black and white and they are happy to compromise on certain aspects as long as their portfolio on the whole is 'responsible' and there's a robust screening process in place. Our in-house model portfolios are then reviewed twice yearly on fixed dates as part of our ongoing service to the clients.

We would note that increasingly investors can access information, support and advice from direct sources of help such as this from BoringMoney underpinned by Morningstar Research.

We suggest it will be increasingly difficult for advisers to argue that the required investment solutions are not available apart from very specific client demands.

Section 7

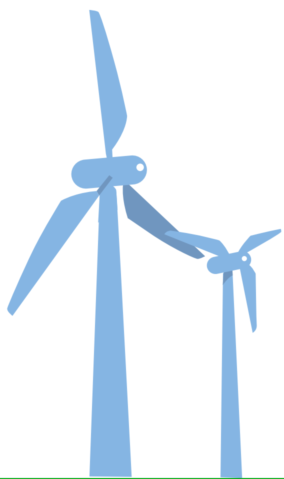
Where do things stand regarding passive and active investing?

Some asset managers argue that only active can deliver sustainability. Others say that pre- defined screens and tilts can deliver sustainable solutions within a passive structure. The UN organisation, the Principles for Responsible Investment published a paper asking "How can a passive investor be a responsible investor?"

Yet we also note that the two giant passive fund managers - Vanguard and Blackrock - are embracing ESG and sustainability across fund ranges and discussing sustainability and climate change in much more detail as this recent letter to clients from BlackRock CEO Larry Fink underlines. He also wrote to CEOs discussing the climate change.

> “ *This is the beginning of a long but rapidly accelerating transition – one that will unfold over many years and reshape asset prices of every type. We know that climate risk is investment risk. But we also believe the climate transition presents a historic investment opportunity.*

Much of this debate is about defending the global passive investment sector against suggestions that it is blind to environmental concerns. The issue for advisers is to understand as always what they are investing in. There are explicit indices based on the sustainability or ESG themes and there are tilts and screens that can be applied to more standard indices. Advisers may also want to understand engagement strategies including CEO letters to companies addressing climate concerns.



Section 8
Is there a risk to business of not adapting?

We would identify three risk areas:

1. Not being prepared for when the regulations come into force.

2. Advisers will increasingly be creating portfolios from a range of securities, both equities and bonds, which in turn face a growing array of rules, regulations, disclosure requirements and incentives which may not be reflected in adviser investment processes.

   Similarly asset managers and pension funds, are facing similar pressures and incentives.

3. It is also possible that clients, especially younger clients, embrace a lot of these concerns or at least want to know their advisers have a view.

Section 9
Client communications

Any significant change in approach to investment advice, whether driven by regulation or initiated by the firm, should form part of marketing and communications.

The terminology remains a little complex with differences between sustainable, ethical, ESG and impact so some explanations will be required.

Communications can also help trail something that is then raised at first meetings and reviews.

We think one of the important aspects to stress is that, by and large, the client is in control and it is their preferences you will reflect. That may apply particularly where clients feel a little bombarded by the issue – much as some advisers are.

You may want a different approach for younger investors and family members who may be much more open and engaged with these conversations.

Guide author

John Lappin

John Lappin is a financial journalist who reports and sometimes commentates on financial services, financial advice and sustainability. Among other things, he is the former editor of Money Marketing, consumer investment title Mindful Money and specialist investment website Global Investment Megatrends.

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