Key Findings

Integrating client preferences for sustainable investment into financial institution legal duties ... still a way to go


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A review of progress towards integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments

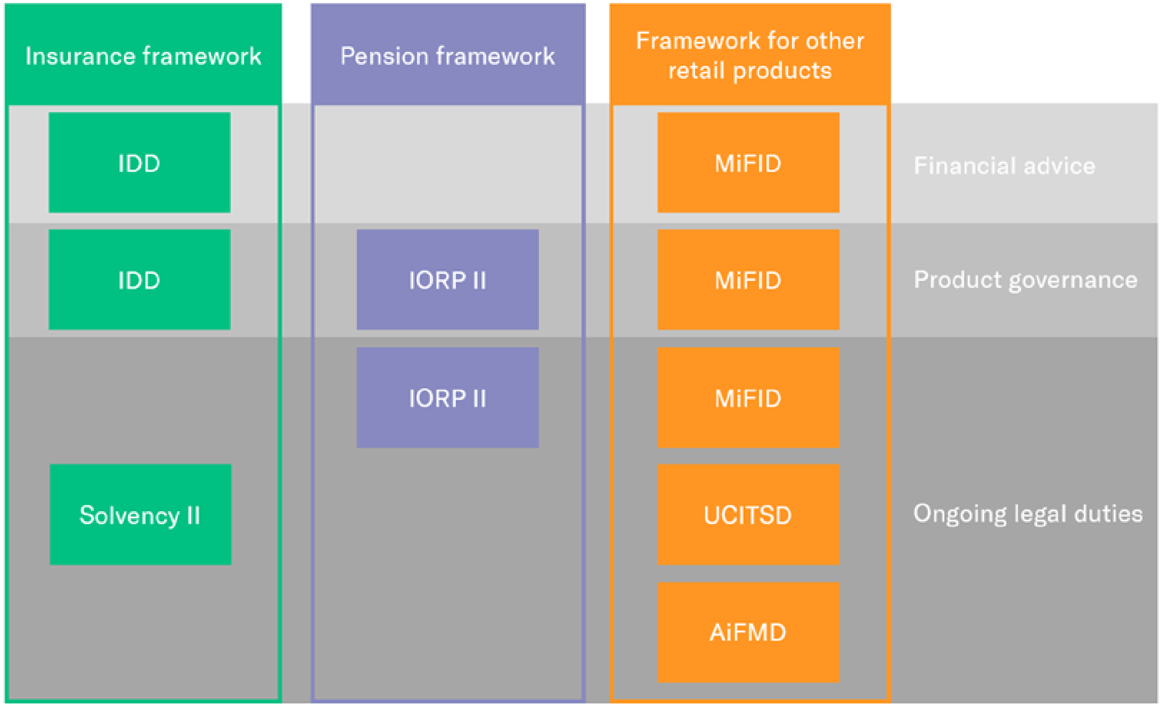
Level the playing field for Energy Efficiency Investment products

Context

- The Commission's *April Package* (published in 2021) contained six amending delegated acts intended to clarify financial institution legal duties to clients in relation to sustainability.
- These regulatory changes integrate client sustainability preferences into investment and insurance advice; update product governance rules to take account of sustainability related objectives of the target market for a financial product; and clarify that ongoing legal duties of financial institutions should take account of sustainability risks and sustainability factors.
- These recast financial institution legal duties are a critical component of the Commission's sustainable finance strategy. They are intended to serve dual objectives of harnessing client preferences for sustainable investment in support of sustainability policy objectives and increasing investor protection through improving financial institution legal duties to clients.

Financial institution legal duties

- Financial institution legal duties to clients are included in several pieces of EU legislation which govern the main categories of financial products and services which retail clients can access.
- Key regulatory silos governing the main categories of financial products and services which retail clients can access include MiFID, UCITS, AiFMD, IDD, Solvency II and IORP II.*
- If legal duties are categorized according to financial advice, product governance and ongoing legal duties then a simplified illustration of how these key regulatory silos can be understood to intersect and overlap with each other is in the diagram.



* Note that the paper does not cover all EU legislation relevant to all possible financial products and services which retail clients can access. For example, it does not cover the Consumer Credit Directive, Mortgage Credit Directive, pan-European Personal Pension Product regulation and others.

EU regulatory changes

- Last year's *April Package* contained the formal regulatory changes to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.
- Billed as an 'ambitious and comprehensive package of measures to help improve the flow of money towards sustainable activities across the European Union,' the April Package included six amending delegated acts. These target each of the frameworks articulated on the previous slide (except for the pension framework) and cover:
  - **introduction of sustainability preferences into investment and insurance advice:** financial institutions must include an assessment of client sustainability preferences during the suitability assessment which must be conducted prior to recommending financial products to clients;
  - **integration of sustainability factors into product oversight and governance:** financial institutions must consider sustainability factors in financial product manufacture and distribution; and
  - **clarification of ongoing legal duties:** financial institutions must consider sustainability risks and factors in ongoing management of client investments.
- The regulatory changes conceptualise financial institution legal duties in a way which seeks to ensure consistency with the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation.

Weaknesses apparent in regulatory changes (1)

- **Impact-oriented financial products are not properly accommodated in the concept of sustainability preferences** Integrating client preferences for sustainable investment into investment and insurance advice relies on a definition of sustainability preferences which does not accommodate impact-oriented financial instruments and does not provide clarity to an already confused marketplace. Assessing sustainability preferences will not reveal if a client is impact-oriented and cannot result in recommending an impact-oriented financial product. As a result, there is a high risk of mis-selling to nearly half of clients who are interested in achieving impact.
- **Concept of sustainability preferences lacks clarity** The definition of sustainability preferences tries to ensure only genuinely sustainable financial products are eligible for recommendation. But the lack of clarity in this definition may result in variable approaches to how financial institutions categorise their products for clients. And the concept does not capture many aspects of how clients want to invest sustainably (i.e. wider sustainability motivations). This variability will work against comparability across the market and will work against the consumer protection objective.

Weaknesses apparent in regulatory changes (2)

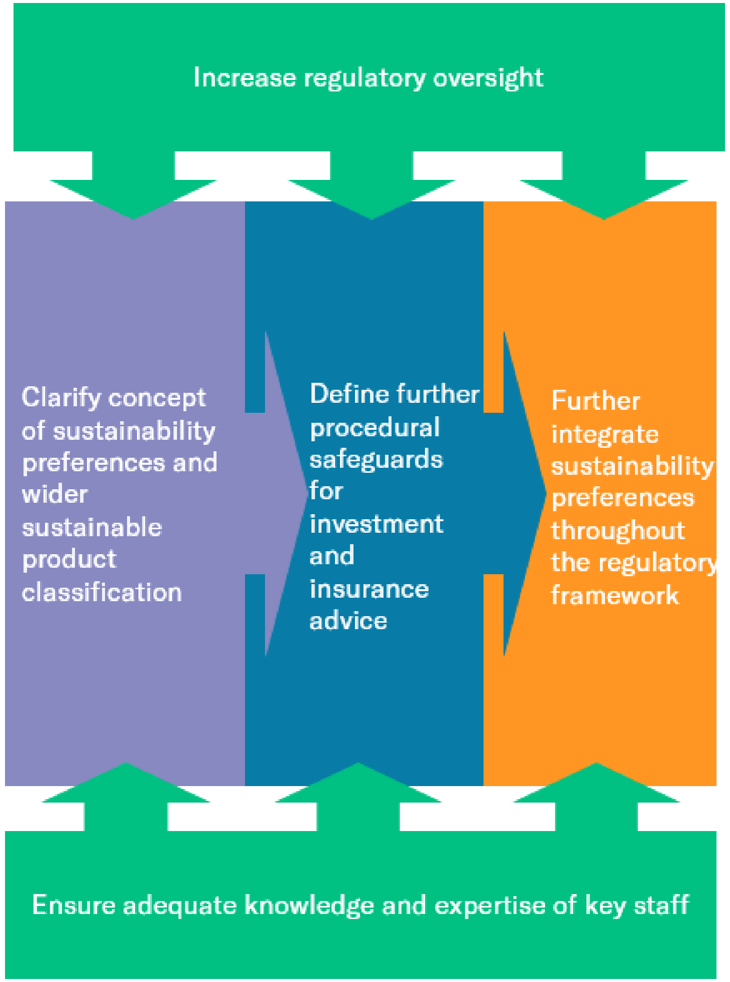
- **Risk of influence for investment and insurance advice** The revised suitability assessment procedure affords plenty of opportunity for advisors to influence how clients express their sustainability preferences. Considering current market practice of advisors, this potential for influence may undermine the objective of establishing a process where advisors must respond in a genuine manner to client sustainability preferences.
- **Uneven integration of the concept of sustainability preferences throughout the regulatory framework** Only the insurance framework requires ongoing decision making to take account of sustainability preferences. There have been no regulatory changes to the pension framework. And for the framework which applies to other retail products, ongoing legal duties are clarified by virtue of updating organisational requirements to include sustainability risks and sustainability factors – but there is no integration of sustainability preferences into these legal duties. In addition, there is regulatory uncertainty in relation to how sustainability related objectives in the product governance obligations intersect with the concept of sustainability preferences.

Weaknesses apparent in regulatory changes (3)

- **Poor regulatory oversight of financial institution compliance with legal duties** The planned route to integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments relies on a level of regulatory oversight (in relation to the suitability assessment and otherwise) which may not exist. Addressing this oversight gap is critical to create an enabling environment which is compatible with integrating sustainability considerations.

Recommendations (1)

- The recommendations identified in the paper are a direct response to each of the identified weaknesses and are structured around the schema articulated here.
- They are structured so that through clarifying the definition of sustainability preferences, the regulatory framework reflects a more accurate conception of client preferences for sustainable investment. Then through ensuring further procedural safeguards for the suitability assessment, advisors are properly incentivized to ensure they respond appropriately to client preferences for sustainable investment. And further integration of sustainability preferences ensures that legal duties in all frameworks is consistent. Finally increased regulatory oversight and ensuring appropriate training for advisors can support and ensure the right enabling environment.



Recommendations (2)

- **Clarify concept of sustainability preferences and wider sustainable product classification** The Commission should use upcoming opportunities (e.g. in relation to setting minimum sustainability criteria for financial products or otherwise) to improve sustainable product categorisation to create a separate category for impact-oriented financial products and clarify the concept of sustainability preferences to improve the foundation for how financial institution legal duties to clients are conceptualised.
- **Detail further procedural requirements for investment and insurance advice** To ensure that financial institution legal duties to clients are correctly conceptualised, EU supervisors and national regulators should seek to detail further procedural safeguards for the suitability assessment so that clients express sustainability preferences free from any influence by advisors.

Recommendations (3)

- **Further integrate sustainability preferences throughout the regulatory framework** In addition to the proposals to integrate sustainability preferences into the pension framework, the Commission should also complete the integration of sustainability preferences throughout the financial regulatory frameworks and clarify how sustainability related objectives intersects with the concept of sustainability preferences.
- **Increase regulatory oversight and ensure adequate knowledge and expertise of key staff** Supervisors and regulators should examine what tools they can use to set supervisory expectations and ensure compliance with the regulatory changes. The Commission, supervisors and regulators should implement measures to ensure sustainability expertise of all staff involved in the suitability process and which are responsible for key aspects of organisational requirements which take account of sustainability risks and sustainability factors.

About our funders and contact details

Access the paper here.

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