Assessing client sustainability preferences… lost in the maze?

Results of a European mystery shopping campaign assessing financial advisor's compliance with new regulatory requirements for the assessment of client sustainability preferences

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Executive Summary

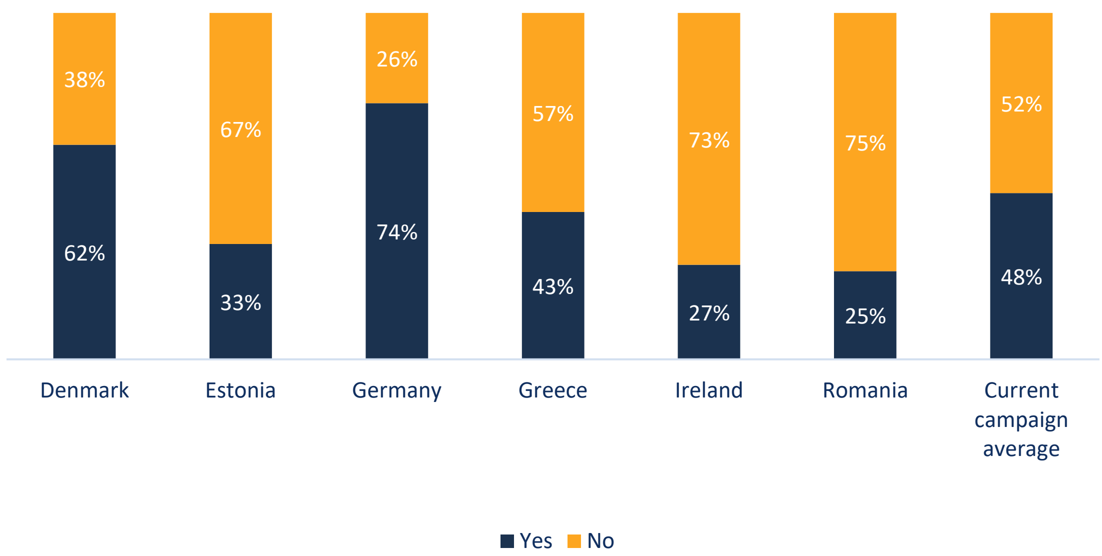
Client preferences for sustainable investment are increasing and ensuring financial institutions take account of these client preferences is a key means to help reorient finance towards a sustainable economy. Through providing investment and insurance advice to clients, advisors can play a central role in this reorientation of finance towards a sustainable economy. To ensure this role is effectively utilised, delegated regulation which came into force in August 2022 now requires advisors to carry out a mandatory assessment of client *sustainability preferences* during the suitability assessment.

This paper summarises **the results of our 2022 mystery shopping campaign to assess advisor behaviour in the context of these new regulatory requirements to assess sustainability preferences**. Our research questions are grouped in three main themes:

- Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment.
- Testing the limits of the regulatory definition of *sustainability preferences* to enable a holistic assessment of client preferences for sustainable investment.
- Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.

The results reveal an alarmingly low level of regulatory compliance. In only 48% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. In addition, there is significant variability in the level of regulatory compliance across target countries. The level of regulatory compliance in Denmark and Germany was much higher than Ireland and Romania. This means that the variability in advisor behaviour observed in our previous 2021 mystery shopping campaign has continued despite these regulatory changes. If one aim of the delegated regulation is to harmonise market practice, then these results clearly indicate this has not yet been achieved.

Appointments where the advisor raised the subject of sustainability preferences without any prompting



The results also show that very few advisors are assessing the minimum proportion of investments which should be invested in accordance with sustainability preferences.[1] **According to the current campaign average, the advisor did not assess the minimum proportion to be invested in accordance with sustainability preferences in 39% of appointments.** In addition, the results raise questions as to whether record keeping by advisors is adequate – both in relation to the initial identification of sustainability

[1] Assessing the minimum proportion is necessary for sustainability preferences sub-paragraph (a) and (b).

preferences and whether the client decides to adapt its sustainability preference (when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed). These procedural steps are the key mechanism to creating the incentives for financial institutions to provide more sustainable financial products over time. Therefore without better compliance with these procedural steps it is unlikely that there will be any incentive structure for investment firms to change the profile of their financial product offering to include more sustainable financial products. This would mean that the whole theory of change for EU sustainable finance policy (in relation to ensuring financial institutions take account of increasing client preferences for sustainable investment meaning that these client preferences are leveraged in support of reorienting finance towards sustainable investment) is critically undermined.

The results show significant limitations to the regulatory definition of sustainability preferences. The definition cannot accommodate impact-oriented financial products (which a significant proportion of clients would be interested in) and it does not operate at the same level of detail (e.g. in relation to specific sustainability topics) which many clients approach the sustainability considerations for their investments.

The results create doubt that an adherence to the regulatory definition of sustainability preferences as a means to assess client preferences for sustainable investment may not work in either the client or the advisor interest. Adhering to the concept of sustainability preferences effectively backs the advisor into speaking a different language to clients – and this creates a risk of mis selling and significantly undermines the procedure articulated for the assessment of sustainability preferences during the suitability assessment.

In terms of advisor sustainable finance knowledge, many mystery shoppers did not reveal any concerns about the level of sustainable finance knowledge of the advisor. While at first glance this appears a positive result, we think the results could reveal something less comforting. The fact that many mystery shoppers did not articulate concerns about the level of sustainable finance knowledge of the advisor is inconsistent with other results which reveal low levels of regulatory compliance generally and generally poor level of knowledge by advisors in relation to accommodating impact-oriented investment opportunities, specific environmental topics and avoiding harmful activities.

One would ordinarily infer from these other results that advisors do in fact have low levels of knowledge – but it appears to be the case that this is not apparent to many clients themselves. Therefore **this raises the question whether this is a situation of both client and advisor being *lost in the maze*.** Whether it is in fact the case that advisors have low levels of knowledge but that clients do not themselves have sufficient knowledge to be in a position where the low advisor knowledge is noticeable and apparent to them.

These results are cause for concern about the operability of the retail focussed aspects of the regulatory framework that has been established following the *Action Plan on Financing Sustainable Growth*. This concern about operability of the framework applies not just to the mandatory assessment of client sustainability preferences during the suitability assessment but also more broadly to the architecture of sustainable financial product categorisation established in the SFDR.

We articulate three recommendations to improve the operability of the regulatory framework and ensure that the financial sector responds appropriately to client preferences for sustainable investment:

- Carry out a coordinated review as soon as possible to assess the level of regulatory compliance with the new suitability assessment requirements and whether the procedure articulated for assessment of sustainability preferences is appropriately designed to contribute towards the policy objective of reorienting finance towards a sustainable economy.
- Clarify the definition of sustainability preferences and wider sustainable financial product categorisation at the earliest opportunity. The Commission should use upcoming opportunities to evaluate the current categorisation approach and conduct a comprehensive impact assessment of possible routes forward.
- Establish a training and certification regime at EU level to ensure advisors gain the necessary expertise in accordance with a framework which articulates the minimum level of sustainable finance knowledge required.

Table of contents

Introduction

Client preferences for sustainable investment are increasing and ensuring financial institutions take account of these client preferences is a key means to help reorient finance towards a sustainable economy. Through providing investment and insurance advice to clients, advisors can play a central role in this reorientation of finance towards a sustainable economy. But this role is underutilised – our previous 2021 mystery shopping campaign showed that financial advisors do not proactively ask clients about their preferences for sustainable investment. This means that clients do not express any preferences for sustainable investment which in turn leads to lower observable demand and a corresponding reduced supply of sustainable financial products.

The *Action Plan on Financing Sustainable Growth* targets this disfunction through an action to introduce new requirements for the investment and insurance advice process. Delegated regulation which came into force in August 2022 now requires advisors to carry out a mandatory assessment of client *sustainability preferences* during the suitability assessment. This paper summarises the results of our 2022 mystery shopping campaign to assess advisor behaviour in the context of these new regulatory requirements to assess sustainability preferences. The 2022 mystery shopping campaign builds on our established expertise in this area[2] and targets bank networks in Ireland, Greece, Estonia, Romania, Germany and Denmark. It implements an evolved methodology to both assess the level of compliance with the new regulatory requirements and derive insights as to whether compliance with these new regulatory requirements is adequate for financial advisors to assess client preferences for sustainable investment in a holistic sense. Consequently, our research questions are grouped in three main themes:

- Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment.
- Testing the limits of the regulatory definition of sustainability preferences to enable a holistic assessment of client preferences for sustainable investment.
- Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.

The paper is structured as follows:

- Section 1 summarises 2DII's recent research on client preferences for sustainable investment and the results of our previous 2021 mystery shopping campaign showing that financial advisors are failing to consider client preferences for sustainable investment and therefore have an underutilised role in reorienting finance towards a sustainable economy. It then summarises the recent EU regulatory changes intended to ensure that financial advisors consider client sustainability preferences so that they are leveraged in support of reorienting finance towards a sustainable economy.
- Section 2 details the regulatory requirements and associated guidance relating to the assessment of client sustainability preferences during the suitability assessment, together with our concerns about inherent weaknesses or flaws in these regulatory requirements. This commentary is structured to provide background context and our rationale for the research questions included in the 2022 mystery shopping campaign.
- Section 3 describes the implementation of the mystery shopping visits which provided the results discussed in this paper.
- Section 4 summarises the results pertaining to each of the identified research questions.
- Section 5 includes discussion of the broad trends about current financial advisor behaviour revealed by the results together with targeted recommendations to improve market practice.
- Section 6 sets out concluding remarks.

[2] Our EU wide mystery shopping campaign focussing on sustainable finance is one of the largest in the field (with over 900 visits planned between 2020-2024). This work is supported by different EU research funding from EIT Climate KIC (Elicit Sustainability Investment Preferences (ESIP)), Life IP (Finance ClimAct), Horizon 2020 (LEVEL EEI) and the German Federal Environment Ministry (Sustainable finance and consumer protection in Greece and Czechia (EUKI)).

Information Box: Mystery shopping in the finance sector

In the finance sector, mystery shopping is understood as an undercover research approach to measure quality of customer service and/or gather information about financial products and services and the conduct of financial institutions towards consumers. Mystery shopping involves individuals acting as potential or actual customers and who are trained and briefed to measure key aspects relating to the research focus. The individuals report back their experiences in a detailed and objective way. The interaction may occur at the pre-contractual, contractual or post-contractual phase and may involve purchasing a product/service, asking questions or registering a complaint.[3]

Mystery shopping is gaining momentum as a regulatory oversight tool in the finance sector. By way of example, in France, the AMF has been carrying out mystery shopping since 2011 to assess the conditions under which financial products are marketed. In Germany, starting in 2022, mystery shopping is expected to become a regular feature of BaFin's supervisory actions.

The precise nature of mystery shopping (in terms of detailed scope of activities, areas of focus etc.) may differ according to the financial regulator's oversight mandate. Of those financial regulators that have implemented mystery shopping activities, they have explained that mystery shopping is 'a useful tool to gather information about financial products and services and/or obtain relevant evidence of the activity performed by financial institutions (FIs) or their conduct towards consumers.' Mystery shopping is therefore able 'to complement the information obtained through the general on-site inspection activity' or can be 'initiated following complaints received or a suspicion of infringements and unfair commercial practices.'[4]

However, while it is gaining momentum as a useful oversight tool, only a limited number of financial regulators have carried out mystery shopping activities. Mystery shopping is also conducted by other entities such as publicly funded organisations and state bodies that conduct consumer research, consumer protection organisations or as part of academic research.

Following the ESA review, the mandate of the European Banking Authority (**EBA**) was extended to include responsibility for 'coordinating mystery shopping activities of competent authorities.'[5] To that end, the EBA has collated mystery shopping activities by national competent authorities with a view to sharing experience, learning valuable lessons and identifying good practices.[6] The EBA has also developed a methodological guide[7] to mystery shopping based on its findings and good practices and to support design and implementation of mystery shopping activities. This guide notes that mystery shopping is particularly well suited to:

- assessing compliance with regulatory requirements;
- evaluating whether financial institution staff have an adequate level of knowledge and competence; and
- measuring compliance with and the effects of new regulatory changes.

The focus of the 2022 mystery shopping campaign is squarely within these areas where mystery shopping is particularly well suited, and our approach is informed by and consistent with the methodological guide developed by EBA.

[3] Paraphrased from EBA, 2021, *EBA report on the mystery shopping activities of national competent authorities*
[4] EBA, 2021, *EBA report on the mystery shopping activities of national competent authorities*
[5] Art 9(1)(g) EBA Regulation (2019/2175)
[6] EBA, 2021, *EBA report on the mystery shopping activities of national competent authorities*
[7] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*

Section 1

Financial advice and the transition to a sustainable economy

This section summarises 2DII's recent research on client preferences for sustainable investment and the results of our previous 2021 mystery shopping campaign showing that financial advisors are failing to consider client preferences for sustainable investment and therefore have an underutilised role in reorienting finance towards a sustainable economy. It then summarises the recent EU regulatory changes intended to ensure that financial advisors consider client sustainability preferences so that they are leveraged in support of reorienting finance towards a sustainable economy.

1.1 Client preferences for sustainable investment are increasing

Evidence pointing to the increasing importance of sustainability considerations in client investment decisions continues to grow.[8] 2DII's first research in this area involved a series of quantitative and qualitative surveys conducted in France and Germany and identified that 65% to 85% of retail clients say they want to invest more sustainably when they are asked.[9] But 'wanting to invest more sustainably' is a somewhat superficial analysis of what sustainability objectives retail clients have, what outcomes they expect and how they decide between competing objectives and outcomes. Our research programme has sought to dig deeper into these granular details to understand how – if at all – these objectives and expectations intersect with the range of sustainable financial products currently available.

Our consumer research published during 2022[10] increases the evidence base regarding household beliefs and preferences relating to sustainable finance and reveals variations in interest and preferences for sustainable investment across Member States.[11]

We asked a series of questions regarding the extent to which client investment decision-making features one or more of the following financial/sustainability objectives: (1) aligning investments and savings with values (*value alignment*); (2) achieving an impact in the real world (*achieving impact*); and (3) achieving maximum return for a certain level of risk (*maximising return*). This enabled us to generate a typology of seven profiles, either pure (focussing on one objective only) or mixed (incorporating two or three objectives).

The responses allow several important observations:

- In all countries, most participants fall in mixed profiles: from 50% in Denmark to 71% in Romania (60% on average).
- Among all profiles, the most represented profile mixes all three objectives: 28% of European retail investors want to have it all!
- Overall, maximizing return is the most frequently cited objective: from 62% in Ireland to 78% in Romania (68% on average). But just a small minority of participants only care about maximising returns (20% on average) leaving 80% having at least one sustainability objective.
- Value alignment is the second most cited objective: from 47% in Denmark to 75% in Romania (60% on average).

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[8] See summary of third-party research in 2DII, 2020, *A Large Majority of Retail Clients Want to Invest Sustainably*
[9] 2DII, 2020, *A Large Majority of Retail Clients Want to Invest Sustainably*
[10] See 2DII, 2022, *What do your clients actually want?* and 2DII, 2022, *Jumping the barriers to sustainable retail investment in France*
[11] Denmark, Estonia, Germany, Greece, Ireland, Romania and France

- Achieving impact, despite being the third most cited objective, is still important for a significant fraction of participants: from 35% in Denmark and Estonia to 61% in Romania (46% on average i.e. almost half of all participants).
- In all countries, the ranking of individual financial/sustainability objectives is the same: maximizing return then value alignment and finally achieving impact.

We also asked which sustainability topics would participants prefer to advance through their investments. We proposed a list of 30 sustainability topics out of which participants could select a maximum of six topics. The list included environmental, social and ethical topics in equal proportions (as shown in Table 1 below).

Our results show that while environmental concerns feature more heavily than social concerns (and certain environmental topics e.g. climate change, water, biodiversity feature more heavily than others) there is still a large variety of different concerns held by participants. We also observed in France a similar variety of concerns regarding exclusion topics.

Table 1: List of sustainability topics

Environmental topics	Social and governance topics	Ethical topics
Climate change	Human rights	Abortion and contraception
Fossil fuels	Education	Alcohol
Renewable energy and energy efficiency	Health and safety	Tobacco
Nuclear power	Gender equality	Cannabis
Biodiversity	Diversity	Sugar
Pollution	Labour rights	Gambling
Natural resources	Social inequalities	Pornography
Clean water	Poverty, malnutrition, basic needs	Weapons
Sustainable forestry	Corruption and fraud	Veganism and animal well-being
Genetically Modified Organisms	Local employment	Pork, beef and other religious dietary restrictions

Alongside this heterogeneity of sustainability concerns (either in terms of topics to advance or exclude) we also observed poor knowledge about the four main sustainable finance strategies (thematic investing, best-in-class screening, exclusion and engagement) which prevents participants from discriminating across strategies and identifying those that would be most suitable for their personal sustainability objectives. This is just one aspect of broader concerns about poor sustainable finance literacy by retail investors constraining their ability to invest according to their sustainability objectives.

The current picture regarding client preferences for sustainable investment can therefore be characterised as: *retail clients have increasing preferences for sustainable investment but struggle to get to grips with the technical aspects of sustainable investment.*

If this current picture is viewed in the broader context of increasing consumer distrust of the financial sector[12], growing awareness of the damage caused by greenwashing[13] as well as what some have termed an *ESG backlash* in some countries, we are at a critical juncture in terms of maintaining the momentum and direction of travel for sustainable investment by retail clients.

[12] See 2DII, 2021, *Sustainable finance and market integrity: promise only what you can deliver*
[13] As detailed in the Commission's Request for input to the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) related to greenwashing risks and supervision of sustainable finance policies

1.2 The underutilised role of advisors in the transition to a sustainable economy

Advisors represent a key entry point for individuals to obtain information about financial products, and often represent the main information channel relating to financial investment. Several studies similarly point to the fact that advisors should perform a similar function as the main information channel for sustainability aspects associated with client investments.[14]

The Commission's 2018 *Action Plan: Financing Sustainable Growth*[15] articulated a comprehensive strategy to ensure the financial system supports broader sustainability policy through advancing three objectives:

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

This Action Plan recognises that '[b]y providing advice, investment firms and insurance distributors can play a central role in reorienting the financial system towards sustainability.' In other words, advisors should play a fundamental role in the transition to a sustainable economy.

However (prior to the regulatory changes discussed in Section 2) EU and national regulation on the financial advice process contained no specific requirements to ask about client preferences for sustainable investment.[16] As a result, despite retail clients having increasing preferences for sustainable investment but struggling to get to grips with the technical aspects of sustainable investment (see Section 1.1), many clients do not express any preferences for sustainable investment. This in turn leads to lower observable demand and a corresponding reduced supply of sustainable financial products.

This lack of any formal requirement to ask clients about their sustainability considerations is reflected in the widely divergent financial advisor practice that we have observed in prior mystery shopping campaigns. Our previous 2021 mystery shopping campaign[17] (built on earlier campaigns in France[18]) and focussed on the extent to which financial advisors consider client preferences for sustainable investment in the months ahead of application of the regulatory changes discussed in Section 2. The 2021 campaign revealed that practices across European financial advisors are very heterogeneous, leaving clients vulnerable to variable service quality regarding sustainable finance. Select results from this research[19] are replicated below.

Financial advisor consideration of client preferences for sustainable investment

Our results show with no ambiguity that it is still far from systematic practice for financial advisors to proactively ask clients about their preferences for sustainable investment or their knowledge and experience on the topic.

On average at European level, sustainability objectives, or knowledge and experience of sustainable products are rarely assessed. However, there is variation at Member State level: financial advisors in Denmark and Germany perform better than in other countries especially regarding the assessment of sustainability objectives.

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[14] See summary of these studies in 2DII, 2022, *Please Don't Let Them Be Misunderstood!*
[15] Which builds upon the recommendations from the EU High Level Expert Group on Sustainable Finance.
[16] Although the previous version of the *ESMA Guidelines on certain aspects of the MiFID II suitability requirements* stated that 'ESMA considers it would be a good practice for firms to consider non-financial elements when gathering information on the client's investment objectives, and – beyond the elements listed in paragraph 27 – collect information on the client's preferences on environmental, social and governance factors' (Paragraph 28).
[17] A total of 210 visits carried out in Denmark, Estonia, Germany, Greece, Ireland and Romania and 90 visits in France.
[18] In the context of the Finance ClimAct project – 540 mystery shopping visits are planned in France by 2024.
[19] 2DII, 2022, *Please Don't Let Them Be Misunderstood!*

In relation to whether financial advisors consider client preferences for sustainable investment when they recommend a financial product, the financial advisor received the message clearly and reacted by proposing a sustainable product in only 55% of cases. In the remaining cases, financial advisors waited for multiple signals to propose adequate products or, even worse, failed to propose adequate products.

And after repeatedly mentioning preferences for sustainable investment, mystery shoppers interested in sustainability were only proposed products that were sustainable beyond any doubt in 50% of cases. Other mystery shoppers were proposed financial products with dubious sustainability features (15%), financial products that were clearly inadequate (24%) or no financial product at all (11%).

Financial advisor sustainability knowledge and ability to respond to impact-motivated clients

In terms of financial advisor sustainability knowledge, many shoppers reported a clear lack of knowledge of financial advisors regarding sustainable or green financial products. On several occasions, the lack of knowledge was made obvious due to an excess reliance on product factsheets or brochures. In the same vein, some financial advisors tried to back their proposals and hide their lack of knowledge by relying on vague arguments about the expertise of their bank or by superficially referring to external sustainability labels.

In relation to financial advisor expertise to understand the concept of investor impact[20] and respond to impact-oriented clients adequately, the responses of financial advisors proved that the concept of investor impact is not understood by many advisors. The concept of investor impact is often confused with company impact (26%) or, worse, with financial performance (1%). Conversely, 15% could make the distinction between company impact and investor impact.

Financial advisor influence on client expression of preferences for sustainable investment

According to mystery shoppers, a fairly common practice for financial advisors was to propose conventional financial products with which the financial advisors were probably more familiar and comfortable, even though they did not match the preferences expressed by the mystery shoppers. Some financial advisors appeared to operate in a default mode, neglecting to adapt their advice to the distinct profile of the client. The absence of sustainable products in the range of offer or the financial advisor's lack of knowledge in green or sustainable products seemed to contribute to those non-suitable recommendations.

Very rarely, financial advisors vividly argued against green investing, using general and undocumented statements. More often, financial advisors recommended not to fully invest green and diversify with conventional products for risk management purposes.[21]

[20] When it comes to impact, in general terms this is the causal and additional outcome to the world in comparison with a counterfactual baseline scenario. When applied to companies, company impact and is the additional outcome to the world caused by the company compared to a counterfactual (and hypothetical) scenario when the company would not exist. Similarly, investor impact is the additional outcome to the world caused by the investor compared to a counterfactual scenario when the investor (or funder in the case of financial institutions providing loans) would not exist. Investor impact thus corresponds to the change(s) induced through using different financial products in the impact of investee companies. Investor impact and investee company impact should always be differentiated. An investor might have no impact through investing in a company (as occurs when an investor takes over another investor's stake in a company without affecting the company's activities).

[21] If such recommendations are reasonable when green investing is made through sectoral thematic funds, it does not apply to sector-diversified low-carbon (or ESG) strategies. In addition, this practice raises significant concerns as to legal compliance.

1.3 New regulatory requirements for the suitability assessment

Action 4 of the *Action Plan on Financing Sustainable Growth* relates to introducing a legal duty to consider client *sustainability preferences* during the investment and insurance advice process. Action 4 has led to regulatory changes to both MiFID II[22] and the Insurance Distribution Directive[23] (**IDD**). For the purposes of simplicity we focus the discussion below on MiFID II but the changes to IDD are exactly the same (see *Information Box: Sustainability preferences in insurance advice*).

Under MiFID II, firms providing investment advice and portfolio management services are required to carry out a suitability assessment. The term *suitability assessment* refers to the 'whole process of collecting information about a client and the subsequent assessment by the firm that a given investment product is suitable for him, based also on the firm's solid understanding of the products that it can recommend or invest into on behalf of the client.'[24] Investment firms must obtain the *necessary information* about: (a) the client's investment objectives including risk tolerance; (b) ability to bear risks and therefore financial loss; and (c) experience and knowledge. The assessment is to ensure that any recommended financial product is suitable for the client.

Following Action 4, the consequent delegated regulation[25] (the **Commission Delegated Regulation**) came into force in August 2022 and now requires financial advisors[26] to carry out a mandatory assessment of client *sustainability preferences* as a top up to the assessment of traditional investment objectives during the suitability assessment. Financial advisors should then take these sustainability preferences into account in the selection of financial products that are recommended to clients.

The Commission Delegated Regulation integrates the concept of *sustainability preferences* into the existing regulatory provisions[27] setting out the procedural steps for the suitability assessment. In addition, ESMA has released updated *Guidelines on certain aspects of the MiFID II suitability requirements* (the **ESMA Guidelines**). The purpose of the ESMA Guidelines is 'to clarify the application of certain aspects of the MiFID II suitability requirements in order to ensure the common, uniform and consistent application'[28] of all regulatory provisions. The ESMA Guidelines apply as from six months from the date of publication on ESMA's website in all EU official languages.[29]

The concept of *sustainability preferences* is supposed to ensure that only financial instruments that have some level of sustainability-related materiality are eligible for recommendation to clients who express sustainability preferences. It is defined as follows:

'sustainability preferences' means a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment:

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[22] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

[23] Directive 2016/97/EU of the European Parliament and of the Council of 20 January 2016 on insurance distribution

[24] ESMA Guidelines, p.40.

[25] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

[26] Note that we use the term 'financial advisor' in this paper however the formal regulatory language refers to 'investment firms.'

[27] Contained in MiFID II and Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (**MiFID II Delegated Regulation**).

[28] ESMA Guidelines, Paragraph 5. In addition, 'ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID II suitability requirements, by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.' (ESMA Guidelines, Paragraph 6)

[29] Therefore although the ESMA Guidelines were published they did not yet apply during the period of the 2022 mystery shopping campaign.

> *(a) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of [the Taxonomy Regulation];*
> *(b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of [the Sustainable Finance Disclosure Regulation];*
> *(c) a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client*

The assessment of client sustainability preferences should come after the assessment of traditional investment objectives. Advisors should first obtain the necessary information about the client's knowledge and experience in the investment field, ability to bear risks and investment objectives including risk tolerance. Following this the suitability assessment can then proceed to assess client sustainability preferences through following three steps:[30]

- *Step 1: Explanation of sustainability preferences* Explain the different categories of sustainability preferences to provide sufficient information to enable the client to make an informed decision about his or her sustainability preferences;
- *Step 2: Identification of client sustainability preferences* Ask the right questions to comprehensively assess the client's sustainability preferences;
- *Step 3: Financial product presentation/recommendation* Use the information revealed by the client to make a financial product recommendation.

These regulatory changes are intended to ensure that advisors respond to the changing profile of client preferences for sustainable investment. The Commission is seeking to adapt the financial advice process to leverage these client preferences in support of the broader objective in the *Action Plan on Financing Sustainable Growth* to reorient capital towards sustainable investment. And at the same time, these regulatory changes can be understood as addressing consumer protection issues caused by the current failure to properly take account of client preferences for sustainable investment during investment advice.

[30] Please see Section 2 for further detail on the precise requirements for these procedural steps associated with assessing client sustainability preferences, together with our concerns about inherent weaknesses associated with these procedural steps.

Information Box: Sustainability preferences in insurance advice

Our 2022 mystery shopping campaign focussed on the assessment of sustainability preferences during investment advice (i.e. the MiFID suitability assessment as discussed above). However Action 4 of the *Action Plan on Financing Sustainable Growth* relates to introducing a legal duty to consider client sustainability preferences during the investment and insurance advice process.

The Insurance Distribution Directive (**IDD**) requires insurance intermediaries and insurance undertakings which provide advice to carry out a suitability assessment prior to recommending specific insurance-based investment products to clients.[31] The scope of the IDD suitability assessment is near identical to the scope of the MiFID II suitability assessment for investment advice.[32]

A delegated regulation[33] (the **Commission Insurance Delegated Regulation**) which also came into force on 2 August 2022 expands the scope of the IDD suitability assessment to similarly include customer sustainability preferences[34] and defines sustainability preferences.[35]

Both the obligation and the definition of sustainability preferences are drafted in near-identical language to the Commission Delegated Regulation. Furthermore, EIOPA has released *Guidance on the integration of sustainability preferences in the suitability assessment under the Insurance Distribution Directive (IDD)* although there are subtle differences between this EIOPA Guidance and the equivalent ESMA Guidelines.

[31] Article 9(2) Delegated Regulation (EU) 2017/2359
[32] The differences between the IDD and MiFID suitability assessments are: (a) the IDD suitability assessment obligation applies to insurance intermediaries and insurance undertakings which provide advice, whereas the MiFID suitability assessment obligation applies to MiFID firms which provide investment advice, as well as those which provide portfolio management services, and (b) IDD applies to insurance-based investment products, whereas MiFID applies to financial instruments.
[33] Commission Delegated Regulation (EU) 2021/1257
[34] Article 2(3) Commission Delegated Regulation (EU) 2021/1257
[35] Article 2(1) Commission Delegated Regulation (EU) 2021/1257

Section 2

Research questions

This section details the regulatory requirements and associated guidance relating to the assessment of client sustainability preferences during the suitability assessment, together with our concerns about inherent weaknesses or flaws in these regulatory requirements. This commentary is structured to provide background context and our rationale for the research questions included in the 2022 mystery shopping campaign.

This 2022 mystery shopping campaign represents a significant evolution in our research approach. Previous mystery shopping campaigns (most recently the 2021 mystery shopping campaign) focussed on the extent to which advisors assessed client preferences for sustainable investment in the absence of any formal regulatory requirement to do so. This meant that the design of our research questions and associated methodology could approach the topic in a holistic fashion and from a first principles perspective[36] to assess how advisors assessed client preferences for sustainable investment (if at all).[37]

In contrast, our 2022 mystery shopping campaign took place in the context of new regulatory requirements which articulate a process for a mandatory assessment of client sustainability preferences. Therefore our research questions and methodology has evolved to both assess the level of compliance with the new regulatory requirements and also derive insights as to whether compliance with these new regulatory requirements assists advisors to adequately assess client preferences for sustainable investment in a holistic sense.

Consequently our research questions for the 2022 mystery shopping campaign can be grouped in three themes:

- *Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment.* These research questions test the adequacy of the suitability assessment against the regulatory provisions introduced in the Commission Delegated Regulation.
- *Testing the limits of the regulatory definition of sustainability preferences to enable a holistic assessment of client preferences for sustainable investment.* 2DII has identified various concerns about the extent to which the regulatory definition of sustainability preferences is adequate to provide a comprehensive and holistic understanding of all the myriad of factors, objectives and motivations which retail investors might have for the sustainability aspects of their investments. These research questions test the extent to which the regulatory definition of sustainability preferences creates practical problems during the suitability assessment.
- *Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.* These research questions test whether financial advisors appear to have adequate sustainable finance knowledge to provide financial product recommendations to clients with sustainability preferences.

[36] Most concretely, our research questions and associated methodology did not need to fit to any regulatory definitions or concepts.
[37] Indeed, as demonstrated in Section 1.2, the results of the 2021 mystery shopping campaign provide compelling evidence that financial advisor behaviour is very heterogenous, and therefore regulatory change is necessary if advisors are to consider client preferences for sustainable investment.

2.1 Assessing the level of regulatory compliance

This Section 2.1 articulates research questions to test the level of compliance with the regulatory provisions introduced in the Commission Delegated Regulation. It is structured according to the three steps articulated for assessing sustainability preferences during the suitability assessment (see Section 1.3). For each step we summarise the regulatory requirements and associated guidance together with our concerns about inherent weaknesses or flaws which provides the rationale for the associated research questions.

Are sustainability preferences included in the suitability assessment?

Before testing the *adequac*y of how investment firms are assessing client sustainability preferences, the more fundamental question is whether investment firms have in principle updated their suitability assessment process so that sustainability preferences are included.

The Commission Delegated Regulation integrates the concept of sustainability preferences into existing provisions in the MiFID II Delegated Regulation[38] which set out the procedural steps for the suitability assessment. The assessment of sustainability preferences is now mandatory and represents a significant change to current market practice in relation to the suitability assessment.[39] Therefore investment firms will need to implement many changes to be compliant with the new requirements – from revising operational procedures to ensuring relevant staff develop the necessary expertise.

However, at the open hearing in relation to the consultation on the revised ESMA Guidelines,[40] there was significant pushback expressed by financial institutions revealing a collective inertia in response to these regulatory changes. This inertia on the part of financial institutions, taken together with our concerns about the level or regulatory oversight which will be afforded these regulatory changes[41] means there is a real risk that investment firms have not yet revised their operational procedures or ensured relevant staff develop the necessary expertise so that sustainability preferences are included in the suitability assessment.

Research Question 1: Do advisors bring up the subject of sustainability preferences without any prompting?

Explanation of sustainability preferences

Regulatory requirements and guidance

Investment firms should explain the distinction between financial instruments which fall into one of the three categories of client sustainability preferences and financial instruments which do not have the same features (and should not be eligible for recommendation to a client that has expressed sustainability preferences).[42] Otherwise, there is a requirement to provide a description of the types of financial instruments considered, the range of financial instruments and providers and where relevant the sustainability factors taken into consideration in the selection process of financial instruments.[43]

Available guidance does not go much further. Investment firms should 'explain the terms and the distinctions between the different elements of the definition of sustainability preferences […] in a clear manner, avoiding

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[38] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (**MiFID II Delegated Regulation**)
[39] See 2DII, 2022, *Please Don't Let Them Be Misunderstood!*
[40] Held on 18 March 2022 from 10.00 to 12.00 (CET) https://www.esma.europa.eu/press-news/hearings/open-hearing-consultation-guidelines-certain-aspects-mifid-ii-suitability
[41] See 2DII, 2022, *Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go*
[42] Recital 6, Commission Delegated Regulation
[43] Art 52(3), MiFID II Delegated Regulation

technical language. Firms should also explain terms and concepts used when referring to environmental, social and governance aspects.'[44]

2DII concerns

For clients to be able to articulate and advocate effectively in relation to their own sustainability preferences, they must be provided with an explanation of sustainability preferences. Without an explanation of sustainability preferences being provided to the client, any assessment of the client's own sustainability preferences will be inherently flawed.

Research Question 2A: Do advisors provide an explanation of sustainability preferences?

The explanation of sustainability preferences is critical to enable the client to understand the different degrees of sustainability which are possible for financial instruments. The explanation should provide accurate and sufficient information to enable clients to take informed decisions. However, there is almost no guidance on what constitutes an adequate explanation of sustainability preferences.

The regulatory definition of sustainability preferences is complicated and involves several concepts (taxonomy, sustainable investment, principal adverse impacts etc.) which are likely to be new to many clients. In addition, clients will have varying levels of financial literacy and knowledge and interest in sustainability issues. There is a risk that diving straight into an explanation of sustainability preferences is a dry, technical discourse which is simply lost on the client. In the absence of any detailed guidance about what should be included in the explanation of sustainability preferences, there is a question as to what is the prevailing market practice about what is included?

Research Question 2B: What is typically included in advisors' explanation of sustainability preferences?

Investment firms may introduce unconscious bias in the explanation of sustainability preferences and therefore influence how clients understand and express their own sustainability preferences. An unconscious bias can be driven by various factors including the existence of an inducement to recommend certain financial instruments or the advisor's knowledge and preconceptions about different aspects of sustainable financial products (cost, financial return, level of risk etc.). In addition clients can be influenced through an explanation of sustainability preferences which does not relate to all sustainable financial products available on the market but is instead geared towards the financial products that the investment firm is able to recommend.

Research Question 2C: Are the explanations of sustainability preferences provided by reference to all financial products available on the market (or limited to the financial products which an advisor can recommend) and was the explanation provided in a neutral and unbiased manner?

Providing an adequate explanation of sustainability preferences, in a way which the client *genuinely* understands, is not a simple exercise. And there is no regulatory provision or guidance to ensure that the explanation of sustainability preferences is conceived so as to work for the client and that investment firms cannot simply rely on having provided dry, technical content which is not understood by the client.[45]

Research Question 2D: Do advisors check whether the client understands the explanation of sustainability preferences?

[44] Paragraph 16, ESMA Guidelines
[45] Note that Paragraphs 30-31, ESMA Guidelines refers to investment firms appraising client understanding of other notions but understanding of sustainability preferences and other sustainable finance concepts is not included.

Identification of client sustainability preferences

Regulatory requirements and guidance[46]

The obligation to identify client sustainability preferences is in terms of the need to obtain from clients the *necessary information* to understand their position and be able to determine that a financial product recommendation meets the investment objectives of the client, including the client's risk tolerance and any sustainability preferences.[47]

Available guidance specifies that this information should be 'sufficiently granular to allow for a matching of the client's sustainability preferences with the sustainability-related features of financial instruments,' should articulate whether the preference is for one or more category of sustainability preference and should include the minimum proportion or quantitative and qualitative criteria where relevant. Furthermore, investment firms should 'adopt a neutral and unbiased approach as to not influence clients' answers.'[48] [49]

2DII concerns

The identification of client sustainability preferences is an additional area where investment firms may introduce unconscious bias. In a similar manner to clients being influenced through an explanation of sustainability preferences which does not relate to all sustainable financial products available on the market (but is instead geared towards the financial products that the investment firm is able to recommend) clients can also be influenced by investment firms presenting the financial products which it can recommend prior to any genuine attempt to identify client sustainability preferences.[50]

Research Question 3A: Do advisors make a genuine attempt to identify client sustainability preferences and does this occur prior to the presentation of the financial products which the advisor can itself recommend?

Assessing the minimum proportion which a client wants to invest in accordance with sustainability preferences is a further area where clients can be influenced. According to the regulatory definition, the minimum proportion can be anywhere between 0% and 100%. However, at the open hearing in relation to the consultation on the revised ESMA Guidelines,[51] many financial institutions raised a concern that availability of financial products with a high minimum proportion invested in accordance with a sustainability preference was limited, and that if clients expressed a desire for a high minimum proportion, this could not be met. This therefore raises the question as to how investment firms are gathering information about the minimum proportion being invested in accordance with a sustainability preference and whether there is a risk that market practice is influencing clients to articulate a low minimum proportion.

Research Question 3B: How are advisors assessing the minimum proportion to be invested in accordance with sustainability preferences?

Considering our concerns about the level of regulatory oversight which will be afforded these regulatory changes[52], the record keeping obligation is paramount for assessing whether a financial advisor has complied with regulatory obligations. Furthermore, the revised process for the suitability assessment also allows clients

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[46] Note that the research questions articulated here are focussed on assessing the level of compliance with the procedural aspects of identifying client sustainability preferences. Please refer to Section 2.2 for research questions to test the limits of the regulatory definition of sustainability preferences.
[47] Art 54(2) and Art 54(5), MiFID II Delegated Regulation
[48] Paragraph 26, ESMA Guidelines
[49] Note that Paragraph 27, ESMA Guidelines sets out a suggested approach to this process.
[50] Note that the ESMA Guidelines refers to the fact that in the consultation 'consumer associations highlighted instead the need to specify that the assessment of client sustainability preferences should come before any presentation of the financial products to which an investment firm has access to avoid influencing clients' expression of sustainability preferences.' However, this has not been addressed in the final ESMA Guidelines other than to say investment firms should adopt a neutral and unbiased approach.
[51] Held on 18 March 2022 from 10.00 to 12.00 (CET) https://www.esma.europa.eu/press-news/hearings/open-hearing-consultation-guidelines-certain-aspects-mifid-ii-suitability
[52] See 2DII, 2022, *Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go*

to adapt sustainability preferences if no product is available and keep records of that decision. Therefore this process relies on comprehensive record keeping throughout each stage of the suitability assessment.

Research Question 3C: What tools do advisors use to record information?

Financial product recommendation

Regulatory requirements and guidance[53]

Investment firms must ensure that any financial product which is recommended must meet the investment objective of the client, including the client's risk tolerance and any sustainability preferences.[54] Where the investment firm is not able to recommend a financial product which meets the client's sustainability preferences, the client can decide to adapt its sustainability preferences in which case the investment firm shall keep records of this client decision and the reasons for that decision.[55]

Available guidance provides more detail on specific circumstances.[56] In relation to circumstances where a firm intends to recommend a product that does not meet the initial sustainability preferences 'it can only do so once the client has adapted his/her sustainability preferences. The firm's explanation regarding the reason to resort to such possibility as well as the client's decision should be documented in the suitability report. Firms are reminded that this possibility only refers to the sustainability preferences and that with regard to the other criteria of the suitability assessment, the product has to meet the client profile and otherwise shall not be recommended.'[57] Any adaptation should also be documented in the suitability report and 'be subject to the regular monitoring procedures.'[58]

2DII concerns

In view of the permitted mechanism for clients to adapt their sustainability preferences as originally expressed, the financial product recommendation is a further area where investment firms can influence clients. In a similar manner to previous points,[59] clients can be influenced to adapt their sustainability preferences to the product range of the investment firm where they are not made aware that suitable financial products might be available elsewhere on the market as part of the process of offering the client the opportunity to amend its sustainability preferences.[60]

Research Question 4A: Where advisors are unable to recommend a financial product as matching client sustainability preferences, are advisors transparent that suitable financial products might be available elsewhere on the market and do they influence clients?

As before, considering our concerns about the level of regulatory oversight which will be afforded these regulatory changes[61], the record keeping obligation is paramount for assessing whether a financial advisor has complied with regulatory obligations. With the anecdotal view that there is likely to be a large mismatch

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[53] Note that the research questions articulated here are focussed on assessing the level of compliance with the procedural aspects of making a product recommendation. Please refer to Section 2.2 for research questions to test the limits of the regulatory definition of sustainability preferences.
[54] Art 54(2) MiFID II Delegated Regulation (which also specifies further aspects which a financial product recommendation must satisfy).
[55] Art 54(10) MiFID II Delegated Regulation
[56] Paragraphs 28, 73, 83, 84, 85, 111 ESMA Guidelines are all potentially relevant to the financial product recommendation but are not dealt with in detail here.
[57] Paragraph 82, ESMA Guidelines
[58] This appears to be notably weaker that the text proposed in the consultation draft of the ESMA Guidelines.
[59] For example, clients being influenced through an explanation of sustainability preferences which does not relate to all sustainable financial products available on the market but is instead geared towards the financial products that the investment firm is able to recommend, clients can also be influenced by investment firms presenting the financial products which it can recommend prior to any genuine attempt to identify client sustainability preferences.
[60] Indeed, without this requirement, there is hardly any incentive for investment firms to adapt the product range because clients can simply be directed towards the products in the range and be influenced to adapt their sustainability preferences.
[61] See 2DII, 2022, *Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go*

between client sustainability preferences and available financial products, there is a question as to whether investment firms are taking adequate records to provide the necessary data as to what needs to take place in terms of sustainable financial product innovation.

Research Question 4B: What tools do advisors use to record whether clients adapt sustainability preferences?

2.2 Testing the limits of the regulatory definition of sustainability preferences

This Section 2.2 articulates research questions to test the limits of the regulatory definition of sustainability preferences in terms of its adequacy to provide a comprehensive and holistic understanding of all the myriad of factors, objectives and motivations which retail investors might have for the sustainability aspects of their investments. It is structured according to various concerns 2DII has identified about the limits of the regulatory definition of sustainability preferences. For each concern we provide an explanation of our reasoning which provides the rationale for the research questions.

Specific environmental topics

The regulatory definition of sustainability preferences is articulated as a client's preference for one or more of three categories of financial product.

Table 2: Financial products comprising each category of sustainability preference

Category A	Financial instruments which invest in economic activities providing a substantial contribution to one or more of the following environmental objectives[62] articulated in the Taxonomy Regulation[63]: • 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.
Category B	Financial instruments which pursue sustainable investments more broadly. This is a wider category of financial instruments because it includes economic activities that contribute to other environmental objectives and/or to social objectives.
Category C	Financial instruments that consider negative externalities of investments on the environment or society in terms of principal adverse impacts on sustainability. Principal adverse impacts on sustainability are impacts of investment decisions and advice that result in negative effects on environmental, social and employee matters, respect for human rights, anti-corruption, and anti-bribery matters. Contrary to category A and B, here the financial instrument does not aim at any positive contribution but merely consider negative impacts of the investment on sustainability.

[62] Note that as at the date of this paper, technical screening criteria has only been established for the environmental objectives of climate change mitigation and climate change adaptation.
[63] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

To ensure that only financial instruments that have some level of sustainability-related materiality may be recommended to clients who express sustainability preferences, the definition of sustainability preferences departs from a simple correlation to the categories of sustainable financial product articulated in the Sustainable Finance Disclosure Regulation[64] (**SFDR**).

The key point here is that sustainability preferences are not defined as a simple preference for either an Art 8 or an Art 9 financial product, but rather and Art 8 or an Art 9 financial product *may* match sustainability preferences if that financial product satisfies the criteria in the definition of sustainability preferences (and this is a separate assessment to categorisation for SFDR purposes). While we agree with the implicit conclusion that many Article 8 products fail to demonstrate any sustainability related materiality, an unfortunate consequence is that the definition of sustainability preferences is complicated and presents a confusing picture for clients. Furthermore, the definition is not structured in a way which fits well with how clients approach sustainability considerations associated with their investments. We anticipate that this will cause significant problems for how well the new suitability assessment framework operates.

Our consumer research reveals a large variety of concerns for different environmental topics (see Section 1.1). However, the regulatory definition of sustainability preferences does not explicitly cater to these sustainability topics. Rather the regulatory definition of sustainability preferences refers to broader concepts – such as 'taxonomy alignment', 'sustainable investment' etc. Indeed the environmental taxonomy is structured around six environmental objectives (see Table 2 above) but even here the language and conceptual architecture used can cause confusion to retail clients who are focussed on a particular sustainability topic. Therefore there is a question as to how the definition of sustainability preferences can accommodate clients which want to focus on a specific environmental topic.

Research Question 5A: How do advisors accommodate clients who want to focus on a specific environmental topic (e.g. biodiversity)?

Impact-oriented investment opportunities

As set out previously, the regulatory definition of sustainability preferences is articulated as a client's preference for one or more of three categories of financial product (see Table 2 above). There are other financial products which pursue sustainability related objectives but would not ordinarily fall under the definition of sustainability preferences. This is most clearly illustrated in the case of impact-oriented financial instruments i.e. those which have an objective of delivering additional, intentional and measurable environmental or social impact alongside a financial return (see *Information Box: What are impact-oriented financial products?*).

There is significant uncertainty in relation to how impact-oriented financial products are accommodated (if at all) in the definition of sustainability preferences. And at the same time given the proportion of retail clients who are interested in having an impact in the real economy[65] it is these impact-oriented financial products which are most suitable for a financial product recommendation to these clients.

Research Question 5B: How do advisors accommodate clients who are interested in impact-oriented financial products?

When it comes to being able to prove/demonstrate the impact or any financial product or investment, evaluation requires a complex counterfactual analysis as impact is the additional effect on the world through an action. Beyond presenting the actions that have been deployed to achieve impact, demonstrating investor impact implies providing evidence of additional outcomes in the real economy. The highest level of proof of

[64] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector
[65] See 2DII, 2022, *What do your clients actually want?* and 2DII, 2020, *A Large Majority of Retail Clients Want to Invest Sustainably*

additionality cannot be achieved without running experimental[66] or quasi-experimental[67] scientific methods that compare actual achievements to a counterfactual scenario where the investment would not have been made. Even if well-established and commonly used within public policy and philanthropy, those counterfactual impact evaluation techniques are still largely un-used in the finance sector.

This means that much of the thinking and associated marketing communications as to the environmental impact of financial products and financial institutions is not backed up by evidence or substantiated.[68] In this context, there is a question as to how are advisors communicating on the environmental impact of financial products to impact-oriented clients during the suitability assessment?

Research Question 5C: How do advisors explain or demonstrate the impact of relevant financial products?

Information Box: What are impact-oriented financial products?

Although clients increasingly express interest for impact-oriented financial products, the EU regulatory framework does not provide any clear definition of investor impact.

In France, the Paris Financial Centre Impact Task Force[69] published an Investor Impact Charter that contains a the following definition.

Impact Finance is an investment or financing strategy that aims to accelerate the just and sustainable transformation of the real economy, by providing evidence of its beneficial effects. It is based on the pillars of intentionality, additionality and impact measurement, to demonstrate:
1. The joint search, over time, for an ecological and social performance and a financial return, while controlling the occurrence of negative externalities;
2. The adoption of a clear and transparent methodology describing the causal mechanisms through which the strategy contributes to the targeted environmental and social objectives, the relevant period of investment or financing, as well as the measurement methods – according to the concept of theory of change;
3. The achievement of environmental and social objectives aligned with frameworks of reference, in particular the Sustainable Development Goals, defined at the international, national and local levels.

Building on previous studies of investor impact by the Impact Management Project and University of Zurich, 2DII has mapped the climate impact potential of various finance approaches and developed a Climate Impact Potential Assessment Grid. The grid includes four criteria to assess the climate impact potential of a financial instrument:

- Signalling a commitment to the green energy transition;
- Servicing new or undersupplied markets;
- Providing flexible capital;
- Pressuring funded organisations to align their climate strategy with a 1.5°C scenario.[70]

[66] Like randomized controlled trials or natural experiments.
[67] For instance, difference-in-difference, propensity score matching and synthetic control methods.
[68] Please see further analysis of this problem in 2DII, 2021*, Sustainable finance and market integrity: promise only what you can deliver. A regulatory perspective on environmental impact claims associated with sustainable retail funds in France* and 2DII, 2022, *Fighting greenwashing … what do we really need?*
[69] Established by Finance for Tomorrow in March 2021
[70] 2DII, 2022, *I've got the power! Really?*

Avoiding harmful activities

A further aspect to how the definition of sustainability preferences is not structured in a way which fits well with how clients approach sustainability considerations associated with their investments, is in relation to excluding certain economic activities or sectors from investments.

Our consumer research reveals a large variety of concerns for different exclusion topics (see Section 1.1). However, the regulatory definition of sustainability preferences does not explicitly cater to exclusion topics (unless captured by the principle of do no significant harm). Rather the regulatory definition of sustainability preferences is conceived in terms of support to the broader concepts referred to in the regulatory framework – such as for example 'taxonomy alignment', 'sustainable investment' etc. Therefore there is a question as to how the definition of sustainability preferences can accommodate clients which want to specifically exclude certain sustainability topics (such as tobacco) from their investments.

Research Question 5D: How do advisors accommodate clients who want to exclude specific environmental topics from their investments?

When it comes to the strictness of exclusion policies associated with investment portfolios, there is a wide range of different methodologies provided by financial institutions, ratings bodies etc. This means that an economic activity which is excluded according to one methodology, may not be excluded according to another. In this context, there is a question as to how are advisors explaining that financial products do in fact exclude certain economic activities?

Research Question 5E: How do advisors explain or demonstrate what is excluded from relevant financial products?

Information Box: Investment strategies

There are many different types of sustainable financial instruments which rely on different sustainable financial strategies, including:

- **ESG integration:** financial instruments which include sustainability information alongside financial information in the process of selecting assets;
- **Stewardship (voting or engagement):** financial instruments that seek to use shareholder or investor power to influence corporate behaviour. For example: communicating with senior management and/or boards of companies, filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guidelines;
- **Sector/Norm based exclusion:** financial instruments which exclude from a fund or portfolio sectors, companies or countries based on certain criteria. Exclusion criteria can be based on product categories (e.g. weapons, tobacco), company practices (e.g. animal testing, violation of human rights, corruption) or controversies;
- **Best in class/positive screening:** financial instruments which use positive screening techniques to select companies or countries with the best practices in sustainability topics;
- **Thematic investing:** financial instruments that invest in companies because they positively contribute to the advance of a certain sustainability topic, either environmental or social; or
- **Impact investing:** Investing to achieve positive, social and environmental impacts - requires measuring and reporting against these impacts, demonstrating the intentionality of investor and underlying asset/investee, and demonstrating the investor contribution.
- **Income-sharing:** investments that include a mechanism to donate part of the generated income to charities or NGOs.

Consideration of principal adverse impacts

Category C of the definition of sustainability preferences covers any financial instrument which 'considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client.' Therefore there are two dimensions: first, *which specific* principal adverse impacts are considered by the financial instrument, and second, *how* the financial instrument considers those principal adverse impacts (i.e. the qualitative or quantitative elements).

Both aspects are subject to the choice of the client but for many clients this may not be something which they know about. In addition, there is likely to be significant variability in how advisors assess these two dimensions. Available guidance states that investment firms as a starting point (for determining which principal adverse impacts are considered) 'could test the client's preferences and appetite for PAI integration with regard to the families of PAI indicators as whole, based on a possible focus of the client on environmental, social or governance aspects, using the categories presented in the SFDR RTS (instead of an approach based on each PAI indicator) such as emissions, energy performance, water & waste, etc.' Then in relation to how the specific principal adverse impacts are considered 'the qualitative evaluation could be based on the approaches in which products consider PAI (e.g., exclusion strategies / controversies policies / voting and engagement policies).'[71] But this is only guidance and assessing the different components of this category of sustainability preferences is likely to be highly heterogeneous, with a significant difference between theory and actual practice.

Research Question 5F: How do advisors explain the different methods of considering the negative impacts of investee companies?

Information Box: Wider sustainability motivations

2DII uses the term *wider sustainability motivations* to refer to broader client preferences for sustainable investment which are not covered by the regulatory concept of sustainability preferences.

Wider sustainability motivations therefore cover aspects such as the sustainability objective (i.e. (1) aligning investments and savings with values (*value alignment*); (2) achieving an impact in the real world (*achieving impact*); and (3) achieving maximum return for a certain level of risk (*maximising return*) as discussed in Section 1.1) and specific sustainability topics which a client may want to support or avoid beyond those mentioned in the regulatory concept of sustainability preferences.

Wider sustainability motivations can be used to link a client profile to more product features than the ones described in the regulatory definition of sustainability preferences and can increase the suitability of the recommended product(s).

Please see 2DII's *Questionnaire for assessing client sustainability preferences and motivations* and accompanying *Guidance for assessing client sustainability preferences and motivations* (forthcoming) for what we consider to be good practice for a comprehensive assessment of both sustainability preferences and wider sustainability motivations and a methodology for matching financial product features to sustainability preferences and wider sustainability motivations.

[71] Paragraph 27, ESMA Guidelines

2.3 Advisor sustainable finance knowledge

This Section 2.3 articulates research questions to test whether financial advisors appear to have adequate sustainable finance knowledge to provide financial product recommendations to clients with sustainability preferences. We summarise the regulatory requirements and any associated guidance which is relevant to advisor knowledge together with our concerns about current market practice which provide the rationale for the research questions.

Regulatory requirements and guidance

Investment firms must ensure and demonstrate to competent authorities on request that anybody giving investment advice has the necessary knowledge and competence to fulfil the obligations.[72] Furthermore, investment firms must also be able to demonstrate that they have in place 'adequate policies and procedures to ensure that they understand the nature features, including costs and risks of investment services and financial instruments selected for their clients, including any sustainability factors.'[73]

Available guidance consists of both guidelines in relation to the general requirement to demonstrate necessary knowledge and competence[74] as well as provision in the ESMA Guidelines: 'Staff should also have the necessary knowledge and competence with regard to the criteria of the sustainability preferences […] and be able to explain to clients the different aspects in non-technical terms. To that effect, firms should give staff appropriate training.'[75]

2DII concerns

It is clear from the regulatory requirements and guidance that financial advisors are expected to be knowledgeable about what they are advising on – and this knowledge requirement has been updated to include sustainable finance knowledge. In addition, it is implicit in the process articulated for the assessment of sustainability preferences – from explaining sustainability preferences to identifying client sustainability preferences to making a financial product recommendation – that advisors are competent and proficient in this area.

But our 2021 mystery shopping campaign reveals that only a minority of financial advisors appeared to be knowledgeable about sustainable finance concepts. And in relation to financial advisor expertise to understand the concept of investor impact and respond to impact-motivated investors adequately, the responses proved that the concept of investor impact is not understood by many advisors (see Section 1.2).

Therefore, there is a question whether there has been the necessary step change in terms of financial advisor knowledge and expertise on sustainable finance with the advent of the Commission Delegated Regulation coming into force. While the regulatory requirements and guidance specify knowledge and competence must be sufficient, and that training should be provided, there is no detail on the content of this knowledge requirement or training.

Research Question 6: Do advisors have a good understanding of sustainable finance concepts?

72 Art 25(1), MiFID II
73 Art 54(9), MiFID II Delegated Regulation
74 ESMA, 2017, Guidelines for the assessment of knowledge and competence
75 Paragraph 106, ESMA Guidelines

Section 3

Mystery shopping campaign details

This section describes the implementation of the mystery shopping visits which provided the results discussed in this paper.

3.1 Methodology

As can be seen from the research questions articulated in the previous section, the focus of the 2022 mystery shopping campaign is squarely within the areas where mystery shopping in the finance sector has been deemed to be particularly well suited. Annex 1 details the methodology used for our 2022 mystery shopping campaign and articulates how this is informed by and consistent with the methodological guide developed by EBA.[76]

3.2 Scope of mystery shopping visits covered in this paper

The results discussed in this paper are based on 253 mystery shopping visits carried out from November 2022 to January 2023 in the target countries: Denmark, Estonia, Germany, Greece, Ireland and Romania.

Mystery shopping visits were originally planned to be equally split across all target countries, but due to difficulties in Estonia (only a few banks offer investments and the wait to have an appointment is very long) and Ireland (two banks having left the country meaning there are only four active banks left) we had to refine the spread of mystery shopping visits as per Table 3 below.

Table 3: Geographic breakdown of mystery shopping visits

Country	Number of mystery shopping visits	Number of mystery shoppers	Number of males	Number of females	Face to face interview	Online interview
Denmark	50	9	4	5	42	8
Estonia	18	18	6	12	11	7
Germany	50	10	6	4	42	8
Greece	47	11	6	5	46	1
Ireland	33	10	4	6	24	9
Romania	55	8	4	4	55	0
Total	253	66	30	36	220	33

3.3 Implementation

Mystery shopping visits were conducted by an agency: BARE International. As referred to in Annex 1, 2DII and BARE International worked together closely in relation to: (1) agreeing the spread of mystery shopping visits across different target countries; (2) designing the Feedback Form for mystery shoppers to complete after each appointment; and (3) briefing mystery shoppers in relation to different mystery shopper profiles and the relevant questions to ask for each profile.

[76] See EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*

3.4 Limitations

There following limitations may have impacted on the results discussed in this paper.

- While the intention is to develop insights as to advisor behaviour in relation to the suitability assessment across the EU, the results discussed in this paper relate to mystery shopping visits carried out in six different jurisdictions. Therefore this paper uses the term *current campaign average* when referring to the aggregate average results (as opposed to results at national level). As results from mystery shopping campaigns in more Member States become available (see Section 3.5) this current campaign average will be updated although it will still not cover all Member States.
- The results discussed in this paper relate to 253 mystery shopping visits which should not be regarded as a statistically significant number. In addition mystery shopping visits are spread across six target countries and four different mystery shopper profiles.
- Mystery shopping visits within each target country had a geographic concentration in large cities and conurbations.
- Individuals who carried out the mystery shopping visits will not have been representative of the population (in terms of age, education, ethnicity etc.) in each target country.
- Considering some aspects (few COVID situations, difficulty to find a slot for an appointment) a few visits were made by telephone or video conference which could have altered the perception of the mystery-shopper (for example in relation to how the advisors recorded information).
- Certain mystery shopper feedback is based on subjective feeling rather than objective observations (for example in relation to whether the mystery shopper felt influenced to adapt sustainability preferences or whether the advisor pressured the mystery shopper to choose a financial product).

3.5 Next steps for the mystery shopping campaign

Following the mystery shopping visits discussed in this paper, 2DII will carry out further waves of mystery shopping visits. A total of more than 500 visits, are planned from now to the end of 2024[77]and will cover other EU target countries such as Belgium, Czech Republic, France, Netherlands and Sweden. In aggregate our mystery shopping campaign will build a map of the EU situation regarding how client sustainability preferences are considered following the regulatory changes introducing a mandatory assessment of client sustainability preferences during the suitability assessment.

[77] Through research projects including Finance ClimAct, EUKI, Level EEI.

Section 4

Results

This section summarises the results pertaining to each of the identified research questions.

In relation to data which is more peripheral to the specific research questions, mystery shoppers reported:

- The average duration of an appointment was 27 minutes. This is a surprisingly small amount of time – it would be interesting to see if this average duration has increased following the regulatory changes to introduce a mandatory assessment of sustainability preferences.
- The appointment was with an approximately equal number of male and female advisors (52% male advisors, 48% female advisors).
- The typical job description for the advisor was Customer/Client Advisor.

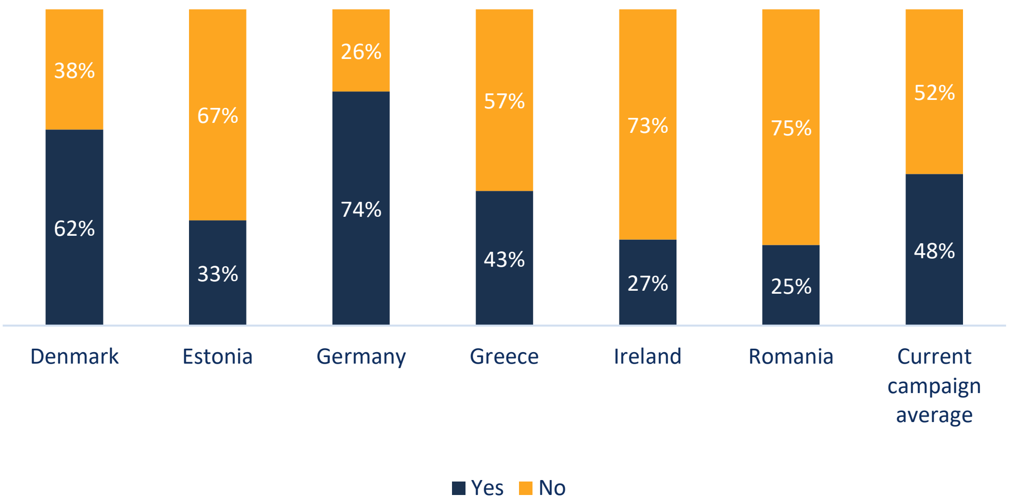
4.1 Assessing the level of regulatory compliance

Are sustainability preferences included in the suitability assessment?

Research Question 1: Do advisors bring up the subject of sustainability preferences without any prompting?

On average, in only 48% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. Therefore the level of regulatory compliance appears to be less than half. However, the results reveal significant variability in the level of regulatory compliance across target countries. Germany and Denmark had the best level of regulatory compliance with more than 60% of advisors bringing up the topic of sustainability preferences, whereas Ireland and Romania had the worst. For the 48% of advisors bringing up sustainability preferences without any prompting, this was after the assessment of traditional investment objectives in 91% of appointments (therefore following the order articulated in the Commission Delegated Regulation).

Figure 1: Appointments where the advisor raised the subject of sustainability preferences without any prompting



Explanation of sustainability preferences

The remaining results to assess regulatory compliance need to be interpreted in the context of the low level of regulatory compliance identified above. In only 48% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. However, mystery shoppers were instructed that where it was absolutely clear that an advisor was not going to raise the subject of sustainability preferences, then the mystery shoppers were instructed to raise the subject themselves.

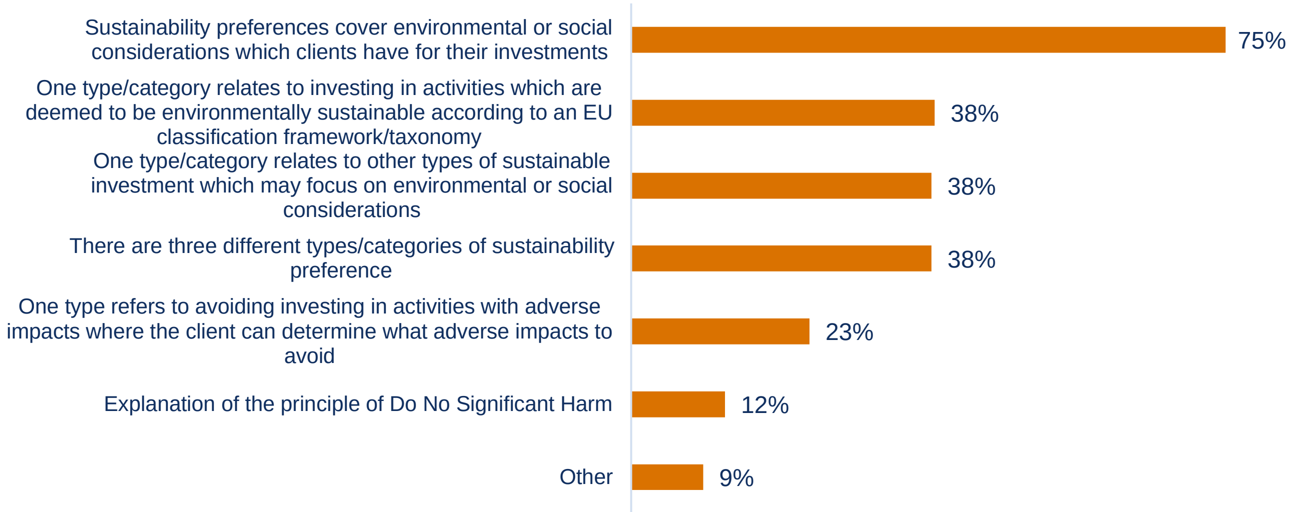
Research Question 2A: Do advisors provide an explanation of sustainability preferences?

According to the current campaign average, advisors provide an explanation of sustainability preferences in 87% of appointments. Of the advisors that brought up the subject of sustainability preferences without any prompting by the client (117 visits), an explanation of sustainability preferences is provided in 98% of appointments. This proportion was largely similar in all target countries. Indeed only three advisors in Germany did not provide an explanation, while 100% of advisors in the remaining target countries provided an explanation.

Research Question 2B: What is typically included in advisors' explanation of sustainability preferences?

However, the content of the explanation of sustainability preferences was not comprehensive. According to the current campaign average, most advisors link the explanation of sustainability preferences to environmental or social considerations that clients have for their investments (75%). However, less than 40% of advisors explain the different categories of sustainability preferences and it is very rare for advisors to explain concepts such as principal adverse impacts or do no significant harm. This broad trend is apparent in all target countries.

Figure 2: Content typically included in the explanation of sustainability preferences (current campaign average, multiple answers possible)



For those mystery shoppers that answered 'Other' (9%), this option was generally used to express a perceived lack of knowledge of advisors. Relevant qualitative feedback here was that some advisors avoided questions by not answering them or responded to specific questions in an evasive manner or spoke in a general way on sustainable finance with no mastery of the topic. In some appointments, clients were invited to do their own research on the website or offered a second appointment to go into the question in more detail.

Research Question 2C: Are the explanations of sustainability preferences provided by reference to all financial products available on the market (or limited to the financial products which an advisor can recommend) and was the explanation provided in a neutral and unbiased manner?

According to the current campaign average, 70% of advisors provided an explanation of sustainability preferences by reference to all financial products available on the market. This result is probably better than expected – for these appointments there is no apparent influence at this step of the sustainability assessment. Results are broadly similar across all target countries, with the best performance being in Germany (84%), Greece (77%) and Romania (76%).

According to the current campaign average, the feedback from mystery shoppers is that 94% of advisors provided a neutral and unbiased explanation of sustainability preferences. However, we query the validity of these results and whether the mystery shopper is in fact able to perceive any bias on the part of the advisor. For example, this result of 94% of advisors providing a neutral and unbiased result is inconsistent with the previous result that only 70% of advisors provided an explanation of sustainability preferences by reference to all financial products available on the market.

Research Question 2D: Do advisors check whether the client understands the explanation of sustainability preferences?

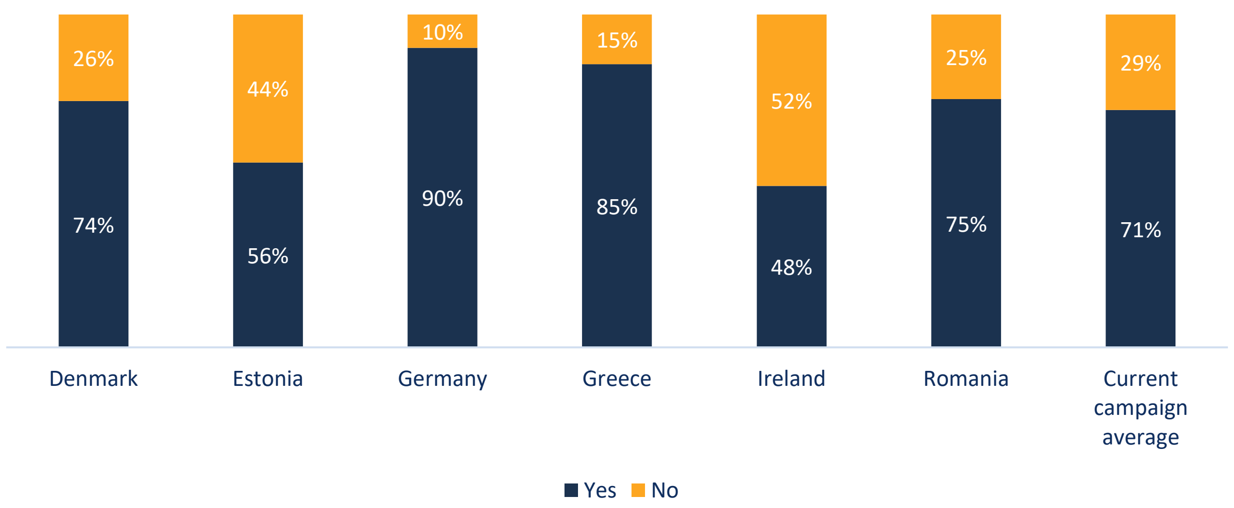
According to the current campaign average, the advisor checked whether the mystery shopper understood the explanation of sustainability preferences in 70% of appointments.

Identification of client sustainability preferences

Research Question 3A: Do advisors make a genuine attempt to identify client sustainability preferences and do this occur prior to the presentation of the financial products which the advisor can itself recommend?

According to the current campaign average, the advisor made a genuine attempt to identify client sustainability preferences in 71% of appointments. However, there is variability across target countries – in Germany and Greece this occurred in 85% or more of appointments, whereas in Ireland it was less than half of appointments. This result shows that in 29% of appointments, the advisor knew that the mystery shopper wanted a sustainable finance product but did not dig into it.

Figure 3: Appointments where the advisor made a genuine attempt to identify client sustainability preferences



Research Question 3B: How are advisors assessing the minimum proportion to be invested in accordance with sustainability preferences?

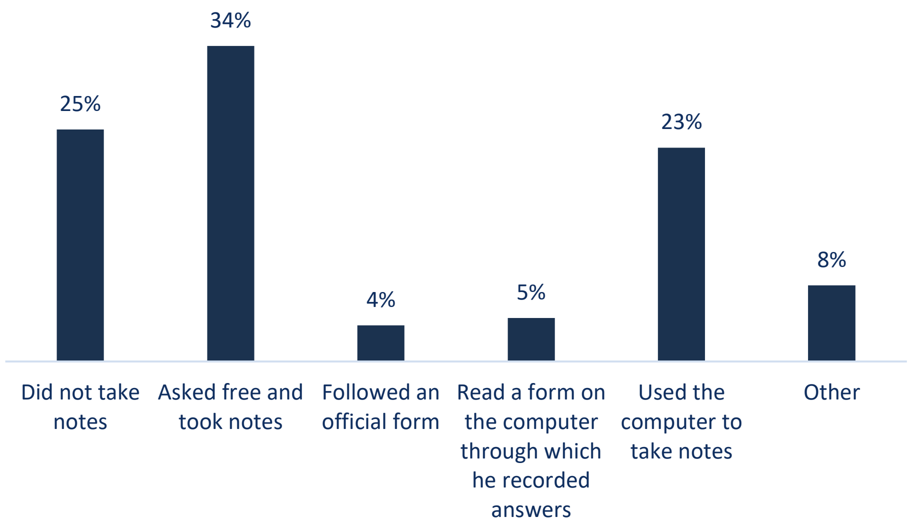
According to the current campaign average, the advisor did not assess the minimum proportion to be invested in accordance with sustainability preferences in 39% of appointments. Meanwhile the advisor presented ranges for assessing the minimum proportion to be invested in accordance with sustainability preferences in 31% of cases. One limitation of this 2022 mystery shopping campaign is that it was not possible to have access to these materials to assess if these ranges were likely to influence how clients articulate the minimum proportion.

Figure 4: Assessment of the minimum proportion to be invested in accordance with sustainability preferences

Research Question 3C: What tools do advisors use to record information?

According to the current campaign average, in 25% of appointments the advisor did not take notes and 34% of appointments the advisor asked free questions and took notes. One limitation of this 2022 mystery shopping campaign is that it was not possible to have access to any of these notes to assess their adequacy. However these results raise significant questions as to whether record keeping practice of advisors is sufficient.

Figure 5: Advisor tools to record information



Financial product recommendation

Research Question 4A: Where advisors are unable to recommend a financial product as matching client sustainability preferences, are advisors transparent that suitable financial products might be available elsewhere on the market and do they influence clients?

We do not consider that we got usable results in relation to the reasons provided by advisors where they are unable to provide a financial product recommendation. Most mystery shoppers received a financial product recommendation (which is a surprising result) and in addition being proposed a second meeting was common (see comments elsewhere that this may have provided an opportunity for advisors who seemed inexperienced or unable to answer client questions on sustainable finance to defer the question until a later stage - thereby proving the opportunity to prepare more fully). Nevertheless, in almost all countries, a minority of advisors admit they do not have in their portfolio a financial product that matches sustainability preferences – and where this was the case many mystery shoppers reported a perceived lack of knowledge and lack of reasons given.

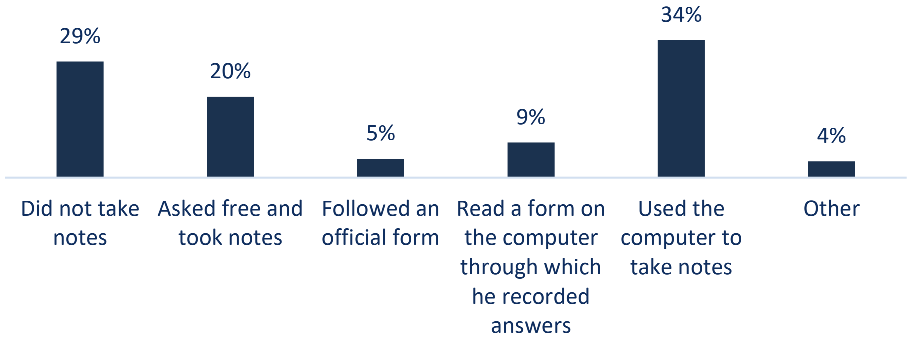
Where an advisor was not able to provide a financial product recommendation and gave the client the option to adapt its sustainability preferences, according to the current campaign average, 70% of mystery shoppers did not feel under pressure from the advisor to choose a product. However, at the same time, 80% of advisors felt that the advisor was not transparent that financial products might be available elsewhere on the market. These results reveal that even if clients are not under pressure to choose a product, they are still subject to information asymmetries.

Figure 6: Appointments where the advisor pressured the client to choose a product and was transparent that financial products might be available elsewhere on the market

Research Question 4B: What tools do advisors use to record whether clients adapt sustainability preferences?

Advisor tools to record client adaptation of sustainability preferences are broadly similar to tools to record information on the identification of sustainability preferences. According to the current campaign average, mystery shoppers provided feedback that use of a computer to take notes increased at this step (34% compared to 23%) and use of asking free questions and take notes decreased. The profile of use of the remaining tools is broadly similar to how advisors record information on the identification of sustainability preferences. As before, one limitation of this 2022 mystery shopping campaign is that it was not possible to have access to any of these notes to assess their adequacy. However these results raise significant questions as to whether record keeping practice of advisors is sufficient.

Figure 7: Advisor tools to record adaptation of sustainability preferences

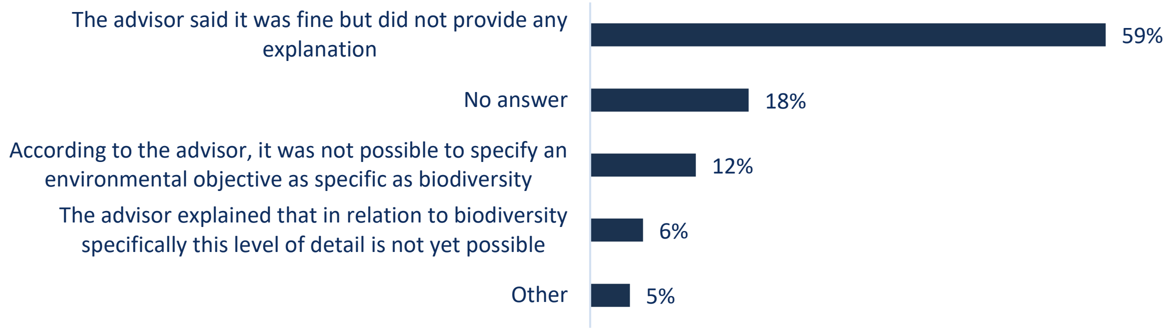


4.2 Testing the limits of the regulatory definition of sustainability preferences
Specific environmental topics

Research Question 5A: How do advisors accommodate clients who want to focus on a specific environmental topic (e.g. biodiversity)?

In general, when the mystery shopper expressed a desire to focus on biodiversity, the advisor response did not provide much information as to how a financial product satisfied this desire. In 59% of cases, the advisor said it was fine but did not provide an explanation.

Figure 8: Advisor response to clients who expressed a desire to focus on biodiversity as an environmental objective



In terms of qualitative results, the best advisor responses to accommodate a focus on biodiversity tended to focus on aspects such as being in receipt of an ecolabel or reference to government controls – although it is not clear whether these advisor responses would have an appropriate specificity. A particularly good example is from Denmark where the advisor explained in detail what companies are in the product portfolio, how a focus on biodiversity is achieved and presented ratios of how the fund is invested in their chosen topic.

However, in general the advisor response to accommodate a focus on biodiversity is substandard and not particularly credible. In Germany, one advisor referred the mystery shopper to basic information documents about the product (where this level of detail would not be apparent) and in Ireland one advisor responded to the biodiversity request by presenting an Article 8 fund. The general position is that most advisors respond through providing general, non-specific and not particularly relevant answers (rather than a specific focus on biodiversity).

Impact-oriented investment opportunities

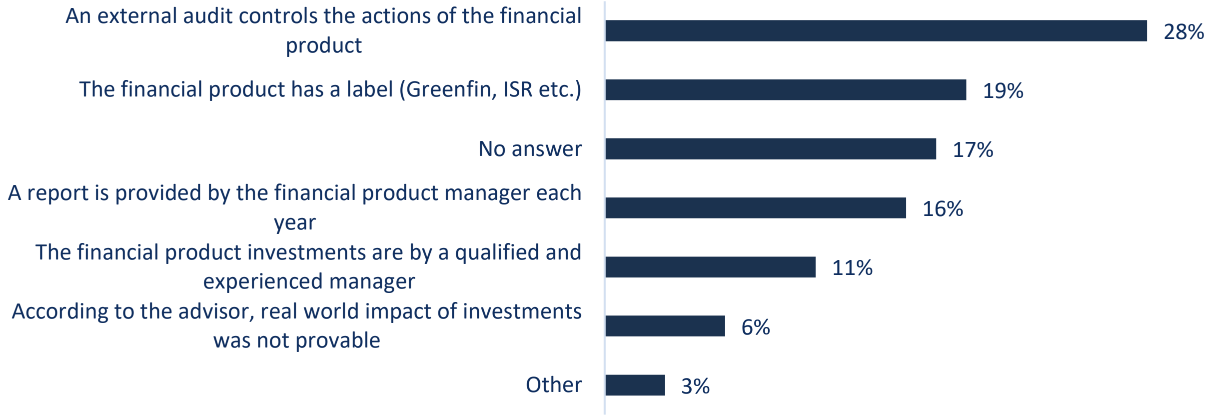
Research Question 5B: How do advisors accommodate clients who are interested in impact-oriented financial products?

The qualitative results here generally reveal that advisors have a lack of knowledge on investor impact. Many advisors explain that a given financial product is impactful without clearly articulating or explaining the concept. Justifications for why a financial product is impact focussed include: funds are controlled by an agency that ensures real impact, details are presented in yearly reports, impact is the main objective of the fund, companies of the fund are certified, information is available on the internet etc.

These are very similar to the explanations we have observed in previous mystery shopping campaigns. We are of the opinion that these explanations do not approximate to genuine and informed thinking and understanding about investor impact. In addition they reveal that general understanding by advisors is not evolving and improving – advisors are saying the same things now as they did in previous years. In a similar manner to how they respond to clients with a specific biodiversity focus (see above) advisors can sometimes adopt a sales approach and seek to persuade the client to trust them.

Research Question 5C: How do advisors explain or demonstrate the impact of relevant financial products?

Figure 9: Advisor explanations of demonstration of the impact of any investment



None of the qualitative results revealed a credible explanation or demonstration of the impact of a financial product. Some advisors encouraged the client to do their own research on the topic while a few advisors in Germany simply said impact could not be proven. Otherwise the qualitative results reveal a lack of clarity both in relation to the concept of investor impact and the evidence as to whether the financial product is achieving impact ("investments are directed only to projects that will not adversely affect the environment", "they will have a very strong impact on the environment", "investing in this sector ensures the world's openness to renewable energy" etc). Superficial (and sometimes erroneous) statements such as these simply do not reflect the emerging practice and thinking around measurement of investor impact and reveal a huge gap between the discourse which advisors *should be having* about investor impact and the discourse which advisors *actually are having* about investor impact.[78]

When it comes to accommodating an impact focus in the financial product recommendation, generally this is not achieved. Some advisors (in Estonia and Greece) oriented the client to the financial aspects of the product and proposed a further meeting to go deeper into the topic while advisors in Romania operated on the basis that impact could not be demonstrated.

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[78] Please see 2DII's *Questionnaire for assessing client sustainability preferences and motivations* and accompanying *Guidance for assessing client sustainability preferences and motivations* (forthcoming) for what we consider to be good practice in this area.

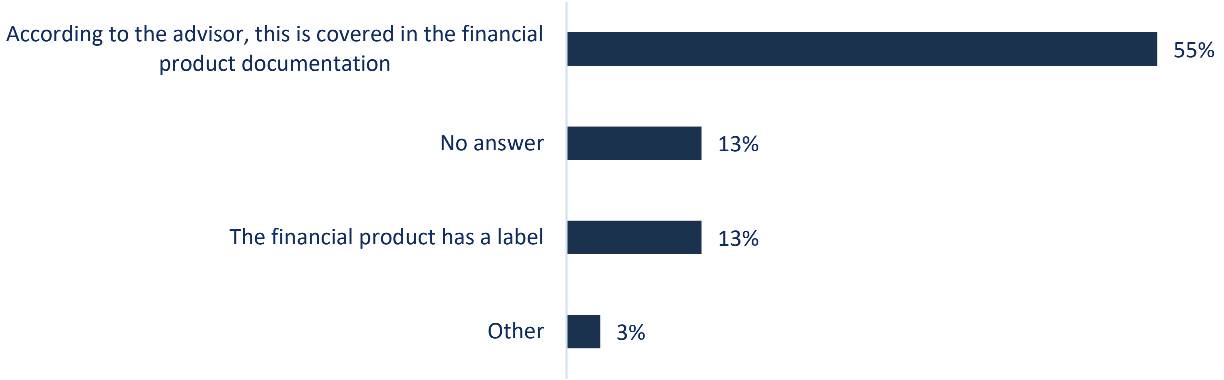
Avoiding harmful activities

Research Question 5D: How do advisors accommodate clients who want to exclude specific environmental topics from their investments?

In relation to clients who want to exclude specific topics from their investment, the qualitative results demonstrate that most advisor responses propose to check the details of the fund or communicate a general position that green/ESG/sustainable investments exclude these activities as a matter of course. It is therefore difficult to interpret the adequacy of these responses as checking the details of the fund might be good, while saying these activities are excluded as a matter of course is not. Other explanations received focussed on broad sustainable finance concepts (rather than a specific focus on pesticides and tobacco) such as the funds being made by top analysts and regulated nationally and internationally. Many advisors effectively batted back the question and said that documentation can easily be found and proposed to clients to do their own research.

Research Question 5E: How do advisors explain or demonstrate what is excluded from relevant financial products?

Figure 10: Advisor response to requests to prove that any investments are in no way connected to pesticides or tobacco

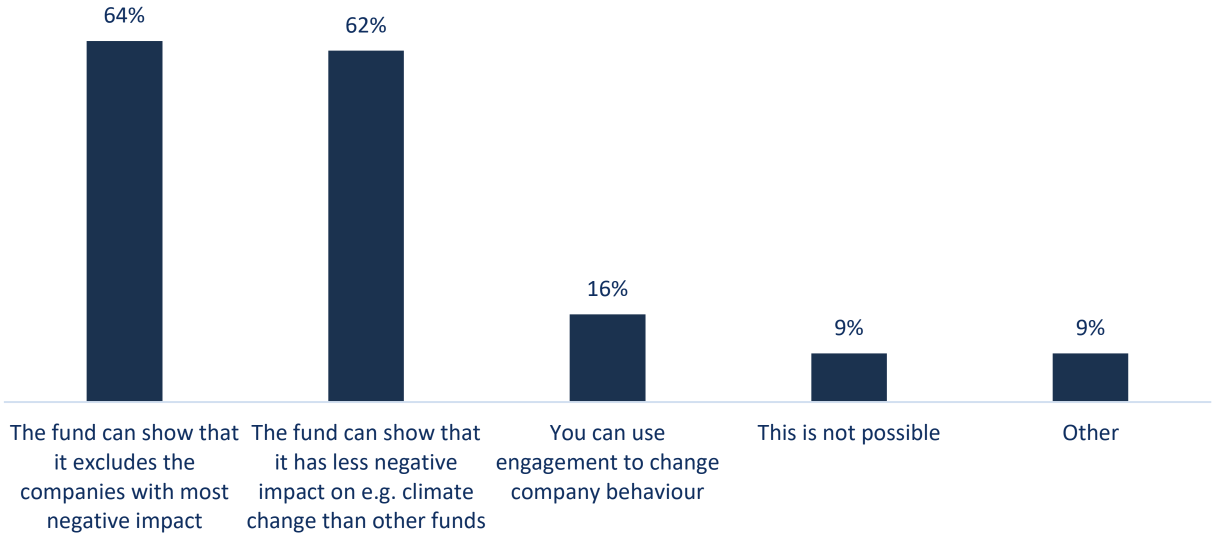


In terms of the qualitative results, we consider that advisor explanations in this area are not sufficient. As noted above, many advisors proposed to clients to do their own research. Others presented documents and ESG ratings of the product arguing that all green investments are not connected with tobacco and pesticides (which is questionable). One advisor said that as the financial product was an Article 8 product it excludes all harmful topics. The results also reveal that this is a particularly confusing area for both clients and advisors – and it is difficult to identify more detailed trends.

Consideration of principal adverse impacts

Research Question 5F: How do advisors explain the different methods of considering the negative impacts of investee companies?

Figure 11: Advisor response to client desire to make sure that any investments are considering negative impact of the companies invested in and aiming to reduce it



4.3 Advisor sustainable finance knowledge

Research Question 6: Do advisors have a good understanding of sustainable finance concepts?

Our commentary in respect of previous results shows a generally poor level of knowledge by advisors in relation to accommodating specific environmental topics, impact-oriented investment opportunities and avoiding harmful activities. This is in addition to the poor level of regulatory compliance generally.

Despite this, many mystery shoppers did not articulate concerns about the level of advisor sustainable finance knowledge. They were satisfied at the end of their appointments and reported positive feedback about the level of enthusiasm and professionalism of advisors, as well as the use of accessible financial language and educational approach to the discussion (e.g. in Denmark and Germany). However, these positive examples of feedback focus on the advisor's general approach and manner – they do not seem to closely relate to the advisor sustainable finance knowledge.

In a significant number of appointments, a second interview is proposed (for which the mystery shopper is requested to provide personal documents) to establish an in-depth recommendation. It also appeared that this provided an opportunity for advisors who seemed inexperienced or unable to answer client questions on sustainable finance to defer the question until a later stage (thereby proving the opportunity to prepare more fully).

Nevertheless many mystery shoppers did provide feedback that the advisor was not familiar with sustainable finance concepts and that many meetings did not add any value or insights compared to what was on the website. In addition, as referred to above, many of the other results would call into question whether the advisor's level of knowledge is sufficient. The results discussed in Section 4.2 reveal a generally poor level of knowledge by advisors in relation to accommodating specific environmental topics, impact-oriented investment opportunities and avoiding harmful activities. Therefore the fact that mystery shoppers did not identify concerns about advisor level of sustainable finance knowledge is somewhat inconsistent. It may be that an advisor's professional approach, experience and confidence in relation to other more established areas of financial advice can mask a lack of specific sustainable finance knowledge.

4.4 Limitations in our results

While these results enable insights in relation to the research questions under our three main themes,[79] one area of weakness is in relation to specific data on what financial products are recommended to clients.

We requested mystery shoppers to record the ISIN number where an advisor recommended a financial product as matching sustainability preferences. This would enable 2DII to independently identify the recommended financial product and access the available product information to make an assessment as to whether the financial product was indeed suitable for recommendation to the mystery shopper (based on the mystery shopper profile).

81% of mystery shoppers recorded an ISIN number following their appointment – from which we can infer that this proportion of mystery shoppers received a product recommendation. As at the date of this paper, we have not been able to analyse the available information for each product to identify trends in how suitable they are for recommendation. However, from a superficial analysis, the fact that 81% of mystery shoppers received a product recommendation is far higher than we would have expected given the sustainability preferences and wider sustainability motivations articulated for each client profile. This would imply that many clients are being recommended financial products which are not suitable for their sustainability preferences.

Further analysis and papers in relation to the 2022 mystery shopping campaign will include analysis of the trends in relation to whether financial products which are recommended are indeed suitable for mystery shoppers (based on the mystery shopper profile).

In addition, we consider that we did not get usable results in the following areas:

- It is the investment firm's choice as to how to provide an explanation of sustainability preferences. One way in which investment firms can ensure the explanation of sustainability preferences is effective (as well as providing assistance to enable regulatory control checks) is to use client explanatory materials. We do have data on what materials advisors used to assist with the explanation of sustainability preferences but could not access these materials to assess their adequacy.
- A potential source of confusion for retail clients is in relation to the relative sustainability performance of different categories of sustainability preference. Even with an adequate explanation of sustainability preferences, and good levels of finance and sustainable finance literacy by the client, the question remains as to which category of sustainability preference is suitable for those clients that want to select the 'most environmental option.' We do not consider that we got usable results to derive any insights into this and the question may not have been fully understood by mystery shoppers and/or financial advisors.
- Financial products which are associated with investor engagement activities to reduce investee company greenhouse gas emissions (i.e. engagement being how the financial product considers the principal adverse impact of climate change) can be suitable for relevant impact-oriented clients. 2DII is particularly interested in how financial advisors understand and accommodate the area of investor engagement to reduce GHG emissions of investee companies. However, we do not consider that we got usable results to derive any insights into this and the question may not have been fully understood by mystery shoppers and/or financial advisors.

[79] (1) Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment; (2) Testing the limits of the regulatory definition of sustainability preferences to enable a holistic assessment of client preferences for sustainable investment (3) Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.

Section 5

Discussion and recommendations

This section includes discussion of the broad trends about current financial advisor behaviour revealed by the results together with targeted recommendations to improve market practice.

5.1 Level of regulatory compliance

Discussion

The results of our 2022 mystery shopping campaign reveal a low level of compliance with the new regulatory provisions requiring a mandatory assessment of client sustainability preferences during the suitability assessment. In only 48% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. We can therefore infer that 52% of appointments would not have included any assessment of sustainability preferences if the client had not itself brought up the subject.[80]

This is an alarming result and potentially indicates that our fears about financial institution inertia in the face of these new regulatory requirements was well founded. In addition, there is significant variability in the level of regulatory compliance across target countries. The level of regulatory compliance in Denmark and Germany was much higher than Ireland and Romania. This means that the variability in advisor behaviour observed in our previous 2021 mystery shopping campaign has continued despite these regulatory changes. If one aim of the delegated regulation is to harmonise market practice, then these results clearly indicate this has not yet been achieved.

The remaining results to assess regulatory compliance need to be interpreted in the context of this low level of regulatory compliance generally. However, these results reveal cause for concern in relation to key aspects of the regulatory procedure articulated in the Commission Delegated Regulation.

For the explanation of sustainability preferences,[81] 87% of appointments included this. But in terms of the content of the explanation, while advisors do link sustainability preferences to environmental and social considerations which clients have for their investments (see Figure 2), many explanations provided by advisors do not go much further than this. Less than 40% of explanations cover the difference between the separate categories of sustainability preference.[82] And hardly any explanations cover key concepts such as do no significant harm.[83] This means that clients cannot be regarded as having got to grips with the relevant concepts (unless they have done their own research outside of the appointment) and therefore should not be viewed as sufficiently empowered to take informed decisions.

The results also show that very few advisors are assessing the minimum proportion of investments which should be invested in accordance with sustainability preferences.[84] According to the current campaign average, the advisor did not assess the minimum proportion to be invested in accordance with sustainability preferences in 39% of appointments (see Figure 4). In addition, the results raise questions as to whether record keeping by advisors is adequate – both in relation to the initial identification of sustainability preferences (see Figure 5) and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally

[80] Mystery shoppers were instructed that where it was absolutely clear that an advisor was not going to raise the subject of sustainability preferences, then the mystery shoppers were instructed to raise the subject themselves.
[81] Required by Recital 6, Commission Delegated Regulation and as referred to in Paragraph 16, ESMA Guidelines
[82] In contrast to Paragraph 16, ESMA Guidelines
[83] While these concepts are not explicitly referred to, Paragraph 16 does state that '[f]irms should also explain terms and concepts used when referring to environmental, social and governance aspects.' We consider that these concepts must be covered if the client is to have a genuine understanding of the regulatory definition of sustainability preferences.
[84] Assessing the minimum proportion is necessary for Category A and Category B of sustainability preferences.

expressed (see Figure 7). While seemingly innocuous, these results raise concerns about whether the regulatory changes are effective in contributing to the desired policy objective.

In theory, the procedure articulated in these regulatory changes is supposed to represent a compromise. Clients can freely articulate their sustainability preferences but are given the option to adapt their sustainability preferences where the advisor cannot recommend a financial product which matches these sustainability preferences as originally expressed, provided that the advisor keeps a record of the client having adapted its sustainability preferences and the reasons for doing so.[85] In addition, this information should be subject to regular monitoring procedures. This is supposed to recognise that ambitious sustainability preferences may not always be satisfied now but is supposed to create an incentive structure so that over time the financial product offering changes to reflect increasing client preferences for sustainable investment.

However, if the minimum proportion to be invested in accordance with sustainability preferences (i.e. a key constituent of the original articulation of client sustainability preferences) is not being assessed, and the record keeping at both this step of the suitability assessment and the step when the client is given the opportunity to adapt its sustainability preferences is not adequate, then there is no evidence as to the extent to which clients are adapting their sustainability preferences. And in turn, where there is no such evidence, it is unlikely that there will be any incentive structure for investment firms to change the profile of their financial product offering. Without this incentive structure, the whole theory of change for EU sustainable finance policy (in relation to ensuring financial institutions take account of increasing client preferences for sustainable investment meaning that these client preferences are leveraged in support of reorienting finance towards sustainable investment) is critically undermined.

Recommendations

We have expressed elsewhere[86] our concerns about the level of regulatory oversight afforded to the suitability assessment. The general obligation of competent authorities in respect of supervision[87] is very broadly drafted. There are no explicit provisions which relate to regulatory oversight of the suitability assessment and any regulatory oversight which does occur will be largely dependent on record keeping obligations which apply to financial institutions (while these results of our 2022 mystery shopping campaign cast doubt as to whether the records kept are sufficient for this purpose).

This contributes to a high degree of variability in oversight and enforcement practices at Member State level. And in addition, it is possible to discern a divergence in relation to the extent to which sustainable finance, climate risk etc. is integrated into each national competent authority's general oversight mandate and investor protection responsibilities.[88]

We are concerned that the planned route to integrating an assessment of client preferences for sustainable investment into the suitability assessment relies on a level of regulatory oversight which may not exist. Addressing this oversight gap at national level is critical to create an enabling environment which is compatible with integrating sustainability considerations. And greater coordination at EU level is necessary to work towards harmonisation of approaches across the EU.

In this context and in view of what our results reveal about current market behaviour in terms of regulatory compliance, we think there is a clear need for a coordinated review at the earliest opportunity.[89] This must be

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[85] Paragraph 82, ESMA Guidelines
[86] See 2DII, 2022, *Integrating client preferences for sustainable investment … still a way to go* and 2DII, 2022, *Fighting greenwashing … what do we really need?*
[87] Article 22 Directive 2014/65
[88] Indeed this will be even more pronounced if the suitability assessment under IDD is also considered as there may well be a different competent authority with oversight responsibilities for this legislation.
[89] The peer review of competent authorities (as referred to in Art 30, Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC) appears to be grant ESMA the authority to conduct reviews

framed in terms of both assessing the level of regulatory compliance and whether the regulatory framework is designed to effectively contribute towards the policy objective.

Recommendation 1: Carry out a coordinated review as soon as possible to assess the level of regulatory compliance with the new suitability assessment requirements and whether the procedure articulated for assessment of sustainability preferences is appropriately designed to contribute towards the policy objective of reorienting finance towards a sustainable economy

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5.2 Limits of the regulatory definition of sustainability preferences

Discussion

The definition of sustainability preferences is the *bridge* between the sustainable finance silo of regulatory provisions[90] and the retail investor silo of regulatory provisions.[91] And the three categories of financial product included in this definition is the lens through which the financial regulatory framework looks at the myriad of factors, objectives and motivations which retail investors have for the sustainability aspects of their investments.

The results of our 2022 mystery shopping campaign reveal significant concerns as to whether the definition of sustainability preferences provides a sound basis for a comprehensive and holistic assessment of client preferences for sustainability investment. Indeed we have a fear that approaching the topic of client preferences for sustainable investment through the lens of the definition of sustainability preferences (as now required by the Commission Delegated Regulation) serves only to muddy the water and makes an already complicated area even more so.

For clients that wanted to focus on biodiversity as a sustainability topic, we can observe that when asked specifically about biodiversity, many advisors respond with somewhat superficial sustainable finance tropes. The level of detail in a typical advisor response is not at the same level as retail clients may approach this area. By way of example, focussing on the degree of taxonomy alignment is not the same as focussing on specific sustainability topics to promote or avoid through investments. Furthermore there is a distinct lack of transparency provided by advisors in relation to biodiversity aspects of investments (see Figure 8).

There is a broadly similar picture when it comes to clients who specifically want to exclude certain activities from their portfolio. There is a lack of transparency provided by advisors and a propensity to respond to detailed questions about specific sustainability topics using superficial sustainable finance tropes. We can also observe in the qualitative results that many advisors adopt a sales approach.

The categorisation of financial products in the definition of sustainability preferences does not work – even from a theoretical or conceptual point of view – for impact-oriented financial products. The definition does not accommodate impact-oriented financial products – therefore assessing sustainability preferences will not reveal if a client is impact-oriented and cannot result in recommending an impact-oriented financial product.

For clients that are interested in having an impact in the real world through their investments, the results show a distinct lack of knowledge about key aspects of the topic of investor impact. None of the qualitative results

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which can include an assessment of 'the effectiveness and the degree of convergence reached in the application of Union law and in supervisory practice' and 'the extent to which the supervisory practice achieves the objectives set out in Union law.'

[90] Which may broadly be understood to be the regulation implemented as a consequence of the Commission's 2018 *Action Plan on Financing Sustainable Growth* (e.g. Taxonomy Regulation, SFDR etc.).

[91] Which may broadly be understood as the regulation which governs the framework for retail investment (e.g. MiFID II, IDD etc.)

revealed a credible explanation or demonstration of the impact of a financial product. The results reveal a huge gap between the discourse which advisors *should be having* about investor impact and the discourse which advisors *actually are having* about investor impact.

In aggregate, the results in this paper show significant limitations to the regulatory definition of sustainability preferences. The definition cannot accommodate impact-oriented financial products (which a significant proportion of clients would be interested in) and it does not operate at the same level of detail (e.g. in relation to specific sustainability topics) which many clients approach the sustainability considerations for their investments.

The results create doubt that an adherence to the regulatory definition of sustainability preferences as a means to assess client preferences for sustainable investment may not work in either the client or the advisor interest. Adhering to the concept of sustainability preferences effectively backs the advisor into speaking a different language to clients – and this then creates a risk of mis selling and significantly undermines the procedure articulated for the assessment of sustainability preferences during the suitability assessment.

Recommendations

These results provide further evidence to support our recommendation in previous papers[92] that the definition of sustainability preferences must be clarified and improved. And clarifying the concept of sustainability preferences to counter the above-described weaknesses will also require an improved approach to wider sustainable product classification than currently described in the SFDR. Absent an improved method of sustainable product classification, much of the regulatory architecture to support the improved concept of sustainability preferences will be missing.

Other jurisdictions appear to be progressing with an approach to sustainable product classification which is much more reflective of both (1) the myriad of factors, objectives and motivations which retail investors might have for the sustainability aspects of their investments and (2) the tangible product features which identify and differentiate different categories of financial product. The net result is that different categories of financial product are more clearly delineated from each other and matching client preferences for sustainable investment to financial products is more accurate.

In the UK, the FCA's most recent proposals[93] for sustainable investment labels proposes three categories as shown in Table 4 below.

Table 4: Current FCA proposals for sustainable investment labels

Label	Key distinguishing features
Sustainable Focus	• Sustainability objective. Alongside its financial risk/return objective, a 'sustainable focus' product will have an objective to invest in assets that meet a credible standard of environmental and/or social sustainability, or that align with a specified environmental and/or social sustainability theme. • Primary channel for sustainability outcomes. This category of product would pursue its sustainability goals primarily via the market-led channel of influencing asset prices, and thereby reducing the relative cost of capital of sustainable economic activities/projects. • Secondary channel for sustainability outcomes. Products in this category will also typically pursue continuous improvements in the

[92] 2DII, 2022, *Integrating client preferences for sustainable investment … still a way to go*, 2DII, 2022, *Fighting greenwashing … what do we really need?* 2DII, 2022, *Jumping the barriers to sustainable retail investment in France*
[93] FCA, 2022, CP22/20 *Sustainability Disclosure Requirements (SDR) and investment labels*

	sustainability performance of assets through investor stewardship activities
Sustainable Improvers	• Sustainability objective. Alongside its financial risk/return objective, a 'sustainable improvers' product will have an objective to deliver measurable improvements in the sustainability profile of its assets over time, including through investor stewardship. • Primary channel for sustainability outcomes. This category of product would pursue its sustainability goals primarily via the channel of investor stewardship. The product's stewardship approach would be directed towards encouraging and accelerating improvements in the environmental or social sustainability profile of its assets, including through participation in system-wide initiatives, with flow-on positive implications for environmental and/or social sustainability. • Secondary channel for sustainability outcomes. Portfolio construction and asset selection in 'sustainable improvers' products would be geared towards identifying those assets that are best placed to improve their sustainability profile over time. So, a secondary channel would be the market-led channel of influencing asset prices and the relative cost of capital of more sustainable economic activities/ projects.
Sustainable Impact	• Sustainability objective. Alongside its financial risk/return objective, a 'sustainable impact' product will have an objective to achieve a pre-defined, positive and measurable environmental and/or social impact. • Primary channel for sustainability outcomes. This category of product would pursue its sustainability goals by directing typically new capital to projects and activities that offer solutions to environmental or social problems, often in underserved markets or to address observed market failures. Products would be expected to have a stated theory of change, and to pursue a highly selective asset selection strategy aligned with that theory of change. • Secondary channel for sustainability outcomes. Driving continuous improvements in the sustainability performance of assets through investor stewardship activities would be a secondary channel

In Switzerland, the Asset Management Association Switzerland (**AMAS**) and the Swiss Sustainable Finance (**SSF**) have recommended an approach to integrate sustainability across the asset management value chain including at entity level, product level and the point of sale or distribution level from the end-client perspective.[94] Their recommendations include: (a) definitions of various sustainable investment approaches; (b) minimum criteria for implementation of each sustainable investment approach and related disclosures; and (c) a methodology for matching each sustainable investment approach to three main investor sustainability goals. The three main investor sustainability goals (i.e. positive change, values alignment and financial performance) are aligned with what our own research reveals about client preferences for sustainable investment (see Section 1.1).

Both approaches show that without specific focus on matching sustainable financial products to how client themselves approach the topic of sustainability considerations, there is a risk of systemic mismatch between client expectations and the product features of recommended financial products. The approaches also demonstrate that it is possible to link tangible product features to client expectations and that a method of product categorisation which is linked to these tangible product features provides greater regulatory clarity. These approaches therefore establish a regime which works both in the interests of consumers and for investment firms - and appear to be preferable to the EU approach.

[94] AMAS/SSF, 2021, *How to Avoid the Greenwashing Trap: Recommendations on transparency and minimum requirements for sustainable investment approaches and products*

In the EU framework, the question arises as to what point it makes sense (or becomes an imperative) to revisit the definition of sustainability preferences and wider sustainable product categorisation under SFDR.[95] The legislative review of the SFDR (originally scheduled for before the end of 2022[96]) did not take place and there are no current indications as to when it will. In addition we are fast approaching the period before EU elections when by convention no legislative changes are proposed. And while we are awaiting the *Retail Investment Strategy*,[97] there is no current indication that this will contain any focus on clarifying the definition of sustainability preferences or wider sustainable product categorisation.[98]

At the same time, the ESAs are currently focussed on various matters which closely relate to sustainable product categorisation such as responding to a call for input from the Commission on greenwashing related risks and several consultations (from ESMA in particular) reveal a need for further clarification and detail in relation to sustainable financial product categorisation.[99]

This situation may be likened to sustainable financial product categorisation being a political ‘hot potato’. The ESAs are being asked to address problems in the regulatory framework where many of the reasons for these problems derive from lack of clarity in the regulatory provisions (at either Level 1 or 2) which directly or indirectly relate to sustainable financial product categorisation. Therefore the most effective solution to many of these problems in the regulatory framework is most likely to be regulatory change which must originate from the Commission (which has so far revealed no inclination to do so).

Recommendation 2: Clarify the definition of sustainability preferences and wider sustainable financial product categorisation at the earliest opportunity. The Commission should use upcoming opportunities to evaluate the current categorisation approach and conduct a comprehensive impact assessment of possible routes forward.

5.3 Advisor sustainable finance knowledge

Discussion

In our previous paper,[100] we stated our expectation that the application of the Commission Delegated Regulation will force financial advisors to increase their expertise in relation to sustainability preferences and wider sustainable finance considerations (e.g. the various aspects of what we have termed wider sustainability motivations). However, the results of our 2022 mystery shopping campaign reveal that is questionable whether the necessary step change has taken place in terms of financial advisor expertise.

Many mystery shoppers did not reveal any concerns about the level of sustainable finance knowledge of the advisor. While at first glance this appears a positive result, we think the results could reveal something less comforting.

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[95] In addition to the limits to the definition of sustainability preferences identified in this paper, there is mounting criticism that this categorisation of financial products articulated in SFDR is unclear. Indeed, the ESAs were compelled to write to the Commission requesting clarification of the meaning of ‘promotion’ in the context of Article 8 products and the application of Article 9 (https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_application.pdf)
[96] Art 19, Regulation (EU) 2019/2088
[97] Currently expected for 5 April 2023.
[98] Note that the Commission has indicated in its *Strategy for Financing the Transition Towards a Sustainable Economy* that it will look to set minimum sustainability criteria for financial products that fall under Article 8 SFDR in order to guarantee minimum sustainability performance of such products.
[99] See for example, *ESMA Consultation Paper On Guidelines on funds’ names using ESG or sustainability-related terms* https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related
[100] 2DII, 2022, *Please Don’t Let Them Be Misunderstood!*

The fact that many mystery shoppers did not articulate concerns about the level of sustainable finance knowledge of the advisor is inconsistent with other results gained from the 2022 mystery shopping campaign which reveal low levels of regulatory compliance generally (and low levels of compliance with constituent parts of regulatory procedure) and generally poor level of knowledge by advisors in relation to accommodating impact-oriented investment opportunities, specific environmental topics and avoiding harmful activities.

One would ordinarily infer from these other results that advisors do in fact have low levels of knowledge – but it appears to be the case that this is not apparent to many clients themselves. Therefore this raises the question whether this is a situation of both client and advisor being *lost in the maze*. Whether it is in fact the case that advisors have low levels of knowledge (either in terms of knowledge and competence on key sustainable finance topics or in terms of what is required by the regulatory procedure for the assessment of sustainability preferences) but that clients do not themselves have sufficient knowledge to be in a position where the low advisor knowledge is noticeable and apparent to them.

Recommendations

The message from the Commission and ESMA is clear – investment firms must now ensure that anybody giving investment advice has the necessary knowledge and competence and have in place adequate policies to ensure advisors understand key features (including sustainability factors) of financial products. In addition, the ESMA Guidelines recommend that investment firms should give staff appropriate training. However, while the regulatory framework establishes a knowledge requirement and training obligation there are no further details as to what should be included therein.[101]

EU regulation[102] leaves Member States a wide margin to determine the required competence. Absent any consideration of sustainability preferences, 'knowledge and competence' is explained[103] as having acquired an appropriate qualification and appropriate experience to fulfil obligations under MiFID. As a result, qualifications accepted as proof of appropriate qualification vary significantly across the EU, with some Member States requiring a university and/or professional degree and others relying on specialised national or international certification schemes.[104]

We are aware that the Commission is looking at possible improvements to the quality of financial advice under Action 8 of the Capital Market Union Action Plan.[105] According to this line of enquiry, possible ways forward include strengthening existing standards (e.g. under MiFID II and IDD) and a voluntary pan-EU label for financial advisors which 'could be further explored, notably as part of the future *Retail Investment Strategy*.'[106] At the same time, in the *Strategy for Financing the Transition to a Sustainable Economy*, the Commission states that it 'will encourage greater retail investor engagement by seeking improvements in the level of sustainability expertise of financial advisors, subject to further assessment.'[107]

The results in this paper demonstrate that knowledge and competence in relation to sustainable finance differs widely and that the average level of knowledge and competence of financial advisors is not sufficient to comply with the new requirements for assessment of sustainability preferences during the suitability assessment. This is in addition to the general level of knowledge and competence of financial advisors differing across Member States. This significantly increases the need for urgent action by the Commission.

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[101] And the principles-based guidance in the ESMA's *Guidelines for the assessment of knowledge and competence* and *Guidelines on certain aspects of the MiFID II suitability requirements* do not provide further assistance.
[102] Principally MiFID II and IDD together with supporting guidance from ESMA and EIOPA.
[103] In ESMA, 2017, *Guidelines for the assessment of knowledge and competence*
[104] European Commission, 2022, *Report on the current framework for qualification of financial advisors in the EU and assessment of possible ways forward*
[105] https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan/action-8-building-retail-investors-trust-capital-markets_en
[106] European Commission, 2022, *Report on the current framework for qualification of financial advisors in the EU and assessment of possible ways forward*, p.14
[107] European Commission, 2021, *Strategy for Financing the Transition to a Sustainable Economy*, p.8

Further detail is required in relation to defining a framework which articulates the precise content and minimum level of knowledge to ensure that financial advisors have sufficient expertise on sustainable finance to carry out a comprehensive suitability assessment. And a training and certification regime must be established as a better mechanism to ensure financial advisors do in fact gain the necessary expertise (rather than relying on investment firms providing training which may be of variable quality). This training and certification regime should be established at EU level to ensure a consistent level of knowledge of financial advisors across Member States, but national regulatory authorities would be logical partners to help implement the regime (see *Information Box – AMF case study*).

Recommendation 3: Establish a training and certification regime at EU level to ensure advisors gain the necessary expertise in accordance with a framework which articulates the minimum level of sustainable finance knowledge required.

Information Box – AMF case study

In France, the qualification evidencing the required level of knowledge and competence is through an exam either in-house with AMF or with organisations certified by AMF.[108] While the compulsory AMF examination includes questions about sustainable finance (15 out of 120) there is a clear weakness in that the qualification has a lifetime validity while knowledge and products in the domain of sustainable finance are rapidly evolving.

In addition to the compulsory examination, AMF has recently put in place a new module for verifying the knowledge of professionals in green and responsible finance.[109] However this module is only optional which is somewhat inconsistent with the new regulatory requirements for the suitability assessment (in terms of knowledge and competence and appropriate training).

We also have concerns in relation to the content covered by the optional module. One notable absence is in relation to the concept of investor impact. As the results of this 2022 mystery shopping campaign clearly demonstrate, it is necessary to educate financial advisors on the concept of investor impact (and the differentiation between investee company impact and investor impact) to properly advise clients who want to have a positive impact in the real world. According to the current module program this differentiation is not covered (only company impact is covered in relation to the double materiality concept), but impact funds are covered in relation to *Sustainable asset management strategies*. This would indicate that further content is necessary to harmonise and consolidate the information on the concept of impact.

Furthermore, the current module program only covers understanding the different sustainable financial strategies (exclusion, best-in-class, ESG integration etc.) but does not cover how these relate to any sustainability objectives a retail investor might have (positive impact, value alignment, financial performance etc.). It is clearly of critical importance that financial advisors propose financial products with sustainable financial strategies which are suitable for client sustainability objectives (and wider sustainability motivations). To help financial advisors in this regard and ensure a harmonized approach, the regulator should include in the module information on how to match sustainable financial strategies according to client sustainability objectives.

[108] AMF DOC 2010-09
[109] Instruction DOC 2021-03 *Conditions de certification par l'AMF d'un organisme de formation afin de faire passer l'examen AMF finance durable*

Section 6
Conclusion

The results of our 2022 mystery shopping campaign reveal a low level of compliance with the new regulatory provisions establishing a mandatory assessment of client sustainability preferences during the suitability assessment. This low compliance is observable from a general perspective and in relation to specific regulatory provisions (notably those relating to the explanation of sustainability preferences, the assessment of the minimum proportion and record keeping). This calls into question whether investment firms will be incentivised to change the profile of their financial product offering to accommodate increasing client preferences for sustainable investment. In addition, there is concern that adherence to the regulatory definition of sustainability preferences to assess client preferences for sustainable investment means that advisors are forced to speak a different language to how clients approach the topic and that much of the precise detail of client preferences for sustainable investment cannot be accommodated. Finally the current level of financial advisor knowledge and competence does not appear sufficient to assess sustainability preferences. Indeed, current market practice might be akin to both clients and advisors being lost in the maze – with financial advisors not having sufficient knowledge to carry out a proper assessment of sustainability preferences but clients themselves having inadequate knowledge to identify a poor standard of advice.

These results are cause for concern about the operability of the retail focussed aspects of the regulatory framework that has been established following the *Action Plan on Financing Sustainable Growth*. This concern about operability of the framework applies not just to the mandatory assessment of client sustainability preferences during the suitability assessment but also more broadly to the architecture of sustainable financial product categorisation established in the SFDR.

We have heard anecdotally that the Commission is aware of concerns about operability of the regulatory framework. And fallout over the inclusion of gas and nuclear in the taxonomy, emerging concerns over lack of clarity in the SFDR framework, uncertainty over plans for a social taxonomy (and potentially the ecolabel for financial products) have all contributed to a loss of political capital for the Commission. Worryingly, this may have caused a significant scaling down of sustainable finance ambition. As we understand it, the Commission is considering various measures to deal with these operational concerns – some are more significant than others, but all represent a potential roll back of progress for the sustainable finance agenda.

We consider that any roll back of progress is in nobody's interest. Our consumer research shows that client preferences for sustainable investment are increasing. Any scale back of financial institution accountability to take account of these client preferences goes against consumer protection objectives. Considering regulatory developments in other jurisdictions, any scale back of obligations or regulatory divergence will not provide clarity or harmonisation for financial institutions operating cross border. And most crucially, any scale back would undermine the whole sustainable finance architecture as removing or reducing the requirement on financial institutions to take account of client preferences for sustainable investment undermines the key mechanism to ensure finance is reoriented towards sustainable investment.

We articulate three recommendations in this paper: (1) Carry out a coordinated review as soon as possible to assess the level of regulatory compliance with the new suitability assessment requirements and whether the procedure articulated for assessment of sustainability preferences is appropriately designed to contribute towards the policy objective of reorienting finance towards a sustainable economy; (2) Clarify the definition of sustainability preferences and wider sustainable financial product categorisation at the earliest opportunity. The Commission should use upcoming opportunities to evaluate the current categorisation approach and conduct a comprehensive impact assessment of possible routes forward; (3) Establish a training and certification regime at EU level to ensure advisors gain the necessary expertise in accordance with a framework which articulates the minimum level of sustainable finance knowledge required. We consider that these targeted recommendations are critical to improve the operability of the regulatory framework and ensure that the financial sector responds appropriately to client preferences for sustainable investment – thereby maintaining the integrity of the sustainable finance policy package and avoiding the need to scale back progress to date.

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Legislation

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (**MiFID II**)

Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (**MiFID II Delegated Regulation**)

Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (**Commission Delegated Regulation**)

Directive 2016/97/EU of the European Parliament and of the Council of 20 January 2016 on insurance distribution (**IDD**)

Commission Delegated Regulation (EU) 2017/2359 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products (IDD Delegated Regulation (EU) 2017/2359)

Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021 amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products (the **Commission Insurance Delegated Regulation**)

Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

Annex 1: Methodological approach

Following the ESA review, the mandate of the European Banking Authority (**EBA**) has been extended to include responsibility for 'coordinating mystery shopping activities of competent authorities, if applicable.'[110] To that end, the EBA has collated mystery shopping activities by national competent authorities with a view to sharing experience, learning valuable lessons and identifying good practices.[111] The EBA has also developed a methodological guide[112] to mystery shopping based on the findings and good practices identified in this report and to support design and implementation of mystery shopping activities.

We present in the commentary below an explanation of the methodology used for our 2022 mystery shopping campaign as against the seven steps articulated in the EBA's methodological guide.

Figure 12: Key steps in designing and implementing a mystery shopping activity (EBA)

1. Definition of goals

As mentioned in the main body of this paper, the research questions articulated for the 2022 mystery shopping campaign have been clearly specified and are grouped in three main thematic objectives:

- Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment.
- Testing the limits of the regulatory definition of sustainability preferences to enable a holistic assessment of client preferences for sustainable investment.
- Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.

[110] Art 9(1)(g) EBA Regulation (2019/2175)
[111] EBA, 2021, *EBA report on the mystery shopping activities of national competent authorities*
[112] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*

2. Selection of financial products and distribution channels

The 2022 mystery shopping campaign clearly focuses on sustainable financial products proposed to retail clients who express sustainability preferences during the suitability assessment. It is focussed on financial advisor behaviour for large networks (and does not focus on behaviour of independent financial advisors).

3. Selection of financial institutions

As stated by the EBA, '[i]n most cases, it is desirable for a [mystery shopping] activity to include as many different types of [financial institutions] and/or distribution channels as possible that provide a particular product/service so as to fully capture the diversity of the conduct of [financial institutions] in the market and to allow the conclusions of the [mystery shopping] activity to be robust. Different distribution channels (e.g. intermediaries, platforms) might have a major impact on consumer protection objectives, e.g. a product's suitability or its price/costs.'[113]

The mystery shopping visits covered by this paper covered 76 different banks networks (on average 13 with a minimum of 4 for Estonia and 28 for Germany) and were mostly commercial and cooperative banks.

In terms of geographic breakdown, 'a [mystery shopping] activity benefits if the selection of [financial institutions] in terms of geography is reflective of the aim of the activity. For example, a particular investigation into the conduct of [financial institutions] may benefit from a geographical scope that explicitly covers rural and/or urban areas.'[114]

For objectives of the 2022 mystery shopping campaign, it would have been relevant to include urban and rural areas as there may be a preconception that stronger sustainability preferences can be observed among urban households. However, for practical reasons we opted to impose no geographical constraint in this campaign. As a logical consequence, the concentration of visits in large cities and conurbations is a clear limitation of our campaign.

4. Selection of mystery shoppers and consumer profiles

'The characteristics of the consumer profiles that mystery shoppers should portray can be defined … according to the type of consumers that are meant to be the subjects in the [mystery shopping] activity or that would fall within the target market of the products and services designed by the [financial institutions].'[115]

'A consumer profile describes the characteristics of the individual that the mystery shopper will portray during the exercise, for example in terms of the degree of financial literacy, degree of aversion to financial risk, gender, ethnicity, age and/or other characteristics relevant to effectively achieving the goal of the [mystery shopping] activity.'[116]

This 2022 Mystery Shopping Campaign is focussed only on the part of the suitability assessment which relates to the assessment of sustainability preferences (not the part of the suitability assessment which relates to traditional investment objectives). For this reason all mystery shopper profiles have the same financial situation and investment objectives which are determined as a rough average of the financial and investment objectives articulated for AMF's 2019 mystery shopping campaign.[117] Our mystery shopper profiles differ only in terms of the specific nature of the environmental or social objectives they have for their investments.

[113] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*, Paragraph 20.
[114] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*, Paragraph 21.
[115] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*, Paragraph 25.
[116] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*, Paragraph 26.
[117] AMF, 2019, *Resultats des deux campagnes de visites mystere « risquophobe » et « risquophile » conduites sous MIF 2*

- Profile 1 would like to invest in line with the established concept of sustainability preferences. However Profile 1 must ask the questions articulated below to see how the advisor differentiates between different aspects of the definition of sustainability preferences.
- Profile 2 would like to invest in a way which generates positive impact in the real world. The definition of sustainability preferences does not accommodate impact-oriented financial products. Therefore Profile 2 is designed to investigate how advisors will respond to clients who do not easily fit into the definition of sustainability preferences.[118]
- Profile 3 wants to be sure that its investments are in no way connected to pesticides and tobacco. The definition of sustainability preferences does not accommodate some more granular details about how clients typically want to invest their money. Therefore Profile 3 is similarly designed to investigate how advisors will respond to clients who do not easily fit into the definition of sustainability preferences.[119]
- Profile 4 wants to make sure that any investments are taking negative impacts of companies into account. Profile 4 does not specifically pick up on how exactly he/she wants to consider these negative impacts but makes it clear that negative impacts should be considered and reduced through the investment.

All mystery shopper profiles are not aware of the recent regulatory changes to the suitability assessment but are aware of more sustainable investment opportunities becoming available and would like to invest in a sustainable manner themselves. All mystery shopper profiles have received a lump sum of €50,000 in inheritance, or a proportional equivalent according to the standard of living of the country concerned by the visits, and would like to invest the entirety of this money for the long term (e.g. saving for retirement) and has no need to access any of this money in the short term. All mystery shoppers would like to invest the full €50,000 in accordance with their sustainability preferences/environmental and social objectives.

For each target country, BARE International recruited mystery shoppers from its database selected for already having participated to financial projects. No age criterion was specified and among the mystery shoppers 54% were female and 46% male. Selected mystery shoppers were provided with training (see *Step 5. Design of mystery shopper scenarios*) and had to pass a quiz to check their understanding and if they were adequately prepared for the visit. At the end of the quiz a code was shared if the individual had passed the test. BARE International's Resources Managers encouraged individuals to ask their questions and were made available for further details or questions by mail or phone.

5. Design of mystery shopper scenarios

For each mystery shopper profile, 2DII prepared a scenario/briefing document for the mystery shopper which included: (1) financial situation and investment objectives; (2) exposition of environmental/social objectives for investments and (3) particular points to note and questions for raise during the appointment.

As suggested by the EBA, the scenarios/briefing documents were:

- Targeted (i.e. designed to test the specific attitudes of financial advisors in response to different sustainability preferences)
- Credible (i.e. reflects realistic consumer profiles and requests)
- Straightforward, simple and brief
- Ethical (i.e. does not imply any personal risk or possibility to break the law)

All appointments were directly managed by mystery shoppers who presented themselves at each visit under their real identity. To be correctly directed to a financial advisor who could answer their investment requests,

[118] For example, whether advisors will seek to recommend financial products which are not in fact impact-oriented (but fit under the definition of sustainability preferences) or whether they will be transparent and demonstrate expertise and competence on the impact topic to explain that the definition of sustainability preferences is lacking in this regard, but the advisor can recommend a genuine impact-oriented financial product.
[119] For example, how advisors respond to clients which have more detailed environmental or social objectives.

mystery shoppers were asked to specify the amount of money they wished to invest at each call (€50,000 or a proportional equivalent according to the standard of living of the country concerned by the visits).

According to EBA, 'training and briefing materials serve to train the mystery shoppers on how the interaction should play out. This is critical to ensure consistency, quality, and the overall success of the [mystery shopping] activity, no matter the size or scale. Deploying video training and briefing materials via short, engaging multimedia clips could be seen as an effective way for mystery shoppers to understand better the scenario and adapt to various situations. As part of the training, pilot phases could also be planned for mystery shoppers to test the scenario and to ensure that it makes sense in a real-life situation as well as to check that briefing notes and assessment questionnaires - which should be designed at the same time as the [mystery shopping] scenario is defined … adequately cover all the issues to be reported by the mystery shopper.'[120]

2DII provided a detailed briefing session to BARE International project managers which included exposition of regulatory requirements and any associated guidance which (directly and indirectly) relate to the assessment of client sustainability preferences during the suitability assessment, together with our concerns about any inherent weaknesses or flaws in these regulatory requirements. This was structured to provide background context and our rationale for the corresponding research questions articulated for the 2022 mystery shopping campaign.

Recruited mystery shoppers were offered a training that included both a theoretical part and a practical part in order to get prepared for their interviews with financial advisors. The theoretical part included presentation of MIFID requirements for financial advisors and explanations of sustainable finance key concepts (ESG, SRI, best-in-class, exclusions etc.) and tools (sustainable funds, label etc.). The practical part revolved around particular points to be addressed during the interview for each profile, methods for optimizing appointment scheduling and simulations of interviews.

6. Design of mystery shopper assessment questionnaires

In parallel to the design of the mystery shopper profiles and scenarios/briefing documents, a feedback form/assessment questionnaire for mystery shoppers was prepared. The feedback form includes a set of questions which each mystery shopper must answer immediately after the appointment with the financial advisor.

As suggested by EBA, the feedback form was:

- developed in an organised and systematic manner (i.e. to be completed by all mystery shoppers but with different questions revealing themselves according to the mystery shopper profile used during the appointment);
- objective (i.e. relying on actual observations instead of feelings); and
- as short as possible and linked to the mystery shopping focus.

As for the 2021 mystery shopping campaign, we struggled to limit the number of feedback questions. In the future, we will have to pay deep attention to this problem.

Mystery shoppers were trained in how to complete the assessment questionnaire.

7. Assessment of the findings and follow-up

For post-appointment reporting in the target countries, mystery shoppers completed an online version of the feedback form. Completed responses were reviewed by BARE International's Quality Control team to ensure evaluations were carried out in conformity with the guidelines and in due time. BARE International delivered Excel tables with all results at the end of the mystery shopping campaign.

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[120] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*, Paragraph 34 and 35.

Mystery shoppers were also required to forward any materials received form the financial advisor. They could contact 2DII or BARE International for any additional questions before or after the appointment.

Once the responses to the feedback form and all additional materials were received, 2DII proceeded to analyse the results in a quantitative (for closed questions) and qualitative (for verbatims of open questions) manner, both at country and current campaign average level.