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Sustainable investing and suitability

How are you assessing your customers' sustainable investment preferences?

The financial advice sector is at an inflection point on sustainable investing.

Investment advisers around the world are now required to consider or incorporate their customers' attitudes to sustainable investing in some way, regardless of jurisdiction.

At A2Risk, we know that suitability assessments are crucial for providing appropriate and successful financial advice and recommendations. In this article, we explore the importance of sustainable investment within a regulatory context and why it is a central part of the suitability conversation.

We include details of the new Consumer Duty regime in the UK, and the specific sustainability requirements of MiFID II.

Why sustainable investment is important?

There is a growing body of data that shows that environmental, social and governance (ESG) factors are of high importance to investors of all kinds.[1]

Data from the FCA's latest Financial Lives Survey shows that 81% of adults would like the way their money is invested to do some good as well as provide a financial return[2]. Meanwhile, assets held in ESG-themed products and strategies globally are expected to hit $30trn (£24trn) by 2030.[3]

Sustainable investing is undoubtedly a mainstream consideration for consumers and is shaping government and regulatory policy as more and more people seek out investments that contribute to positive environmental or social outcomes.

The regulatory background

Assessing suitability is already a key requirement for advisers, intermediaries and product providers. It was on the FCA's agenda long before the introduction of Consumer Duty, and European Union (EU) MiFID II[4] rules also require advisers to understand customers' views regarding sustainability.[5]

Regardless of jurisdiction, however, for an adviser to meet suitability requirements will require them to consider sustainable investing attitudes and preferences, given the prevalence of strategies and products that incorporate it in some way.

MiFID II requires advisers to obtain information about their customers' sustainability preferences. This is no easy task; as Deloitte's research[6] found, the level of detail required would mean any suitability questionnaires must be carefully worded and designed to ensure neutrality and robustness of results.

Meanwhile, product rules are changing too. The EU's Sustainable Finance Disclosure Regulation (SFDR) has introduced three categories of products with sustainability-related disclosure requirements.[7]

Article 6	Funds and products that do not integrate sustainability considerations into the investment process.
Article 8	Funds and products that promote environmental and/or social characteristics, among other characteristics. Investments must adhere to good governance practices.
Article 9	Funds and products that explicitly have sustainable investment as their objective.

Product providers continue to wrestle with these definitions, with many having reclassified funds to avoid EU sanctions. From an adviser's perspective, however, the suitability question doesn't change. Advisers still need to properly assess customer attitudes to sustainability before finalising product selection.

In the UK, the FCA has already made clear that it expects advisers to understand a customer's attitude towards sustainable investment as part of the advice process, and it has indicated on several occasions that it will clarify its requirements on this over the next year or so.[8] The FCA has indicated that, as a first stage to deciding on what these should be, it has set up a working group to agree on what advisers need to do and what support they will need.

Following the UK's departure from the EU, regulations regarding sustainable investing in the two jurisdictions are diverging – but not significantly. The FCA has developed a similar product labelling regime[9] to investment products based on their sustainability objectives – which they published in December 2023 as Policy Statement 23/19.[10]

The four labels the FCA has introduced – Sustainability Impact, Sustainability Focus, Sustainability Improvers, and Sustainability Mixed Goals – distinguish between products according to the nature of the objective and the primary channel by which each can achieve or encourage positive sustainability outcomes.

Product labelling will be on a voluntary basis initially, according to the FCA, but the use of labels will be subject to qualifying criteria. This is expected to set a high bar, meaning that some funds with, for example, environmental or sustainability considerations or exclusions incorporated into the investment strategy will still not qualify.

In other jurisdictions, we see evidence that consumer attitudes to sustainable investing are also being embedded in regulation. The Australian Securities and Investments Corporation, for example, is taking a hard line on greenwashing at a corporate level. For advisers in Australia, who are already required to take a customer's long-term interests into account[11], customers increasingly expect them to also consider their views on sustainable investing.[12]

As this last reference indicates, assessing attitudes to sustainable investing is not simply important because of laws or regulations – increasingly it is expected to be best practice.

[1] See for example: Raut, R.K., Shastri, N., Mishra, A.K. and Tiwari, A.K. (2023), 'Investors' values and investment decision towards ESG stocks', Review of Accounting and Finance, Vol. 22 No. 4, p449-465. Link: https://doi.org/10.1108/RAF-12-2022-0353

[2] Source: Financial Conduct Authority, 'Financial Lives 2022 survey – Consumer investments and financial advice – Selected findings', p48. Published 26 July 2023. Link: https://www.fca.org.uk/publication/financial-lives/fls-2022-consumer-investments-financial-advice.pdf

[3] Source: Broadridge Financial Solutions, 'ESG Investments Poised to Reach $30 Trillion by 2030', press release. Published 30 November 2021. Link: https://www.broadridge.com/press-release/2021/esg-investments-poised-to-reach-30-trillion-dollar-by-2030

[4] The second Markets in Financial Instruments Directive (MiFID II) came into force in 2014.

[5] See: Deloitte, 'Sustainability preferences: Complex new EU rules require collection of clients' ESG preferences from August 2022', online article. Published 25 July 2022. Link: https://emearegulatorystrategy.deloitte.com/post/102htcw/sustainability-preferences-complex-new-eu-rules-require-collection-of-clients-e

[6] Ibid.

[7] See SFDR text in full: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32019R2088

[8] Including in DP21/24: Sustainability Disclosure Requirements and CP22/20: Sustainability Disclosure Requirements.

[9] Source: Financial Conduct Authority, 'CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels', consultation paper, p31. Published October 2022. Link: https://www.fca.org.uk/publication/consultation/cp22-20.pdf

[10] https://www.fca.org.uk/publication/policy/ps23-16.pdf

[11] See: 'Embrace ESG or be prepared for loss', blog by Simon O'Connor, CEO of the Responsible Investment Association Australasia, for Independent Financial Adviser. Published 28 March 2022. Link: https://www.ifa.com.au/opinion/30949-embrace-esg-or-be-prepared-for-loss

[12] Source: Responsible Investment Association Australasia, 'From Values to Riches 2022: Charting consumer demand for responsible investing in Australia', research paper. Published 2022. Link: https://responsibleinvestment.org/wp-content/uploads/2022/03/From-Values-to-Riches-2022_RIAA.pdf

Assessing suitability

> **"We note that considering the financial implications of ESG factors in investment decisions is increasingly seen as integral to a firm's meeting its fiduciary duty to clients and consumers. And some consumers' ESG preferences fall short of influencing positive environmental or social outcomes – for instance, they may seek certain exclusions to align with their individual ethics or values. It is important that consumers are able to identify and access such products."**
>
> [Chapter 1 paragraph 1.26, FCA Consultation Paper 22/20, 'Sustainability Disclosure Requirements', October 2022][13]

As this extract from the FCA's consultation paper implies, individual customer expectations will have a major impact on product selection and suitability. It is not enough to direct customers to generic sustainable investment products – advisers must be sure these products are appropriate for each individual customer.

This is also the case in the EU.

> **"The assessment of suitability is one of the most important requirements for investor protection in the MiFID framework… Firms will need to collect information from clients on their preferences in relation to the different types of sustainable investment products and to what extent they want to invest in these products."**
>
> [From a European Securities and Markets Authority press release announcing its final guidelines for investment suitability][14]

In most jurisdictions, if your firm is recommending financial instruments to customers, it should be able to identify these customers' individual sustainable investment preferences, just as it would with attitudes to risk. Subsequent recommendations should reflect the sustainability preferences expressed by the customers as well as their financial objectives.

This is not just because more customers are expressing growing interest in sustainable investing. The FCA has made it clear that explicit requirements may soon be placed on financial advisers requiring them to incorporate investment sustainability considerations in their advice to customers.[15]

Consumer Duty and sustainability

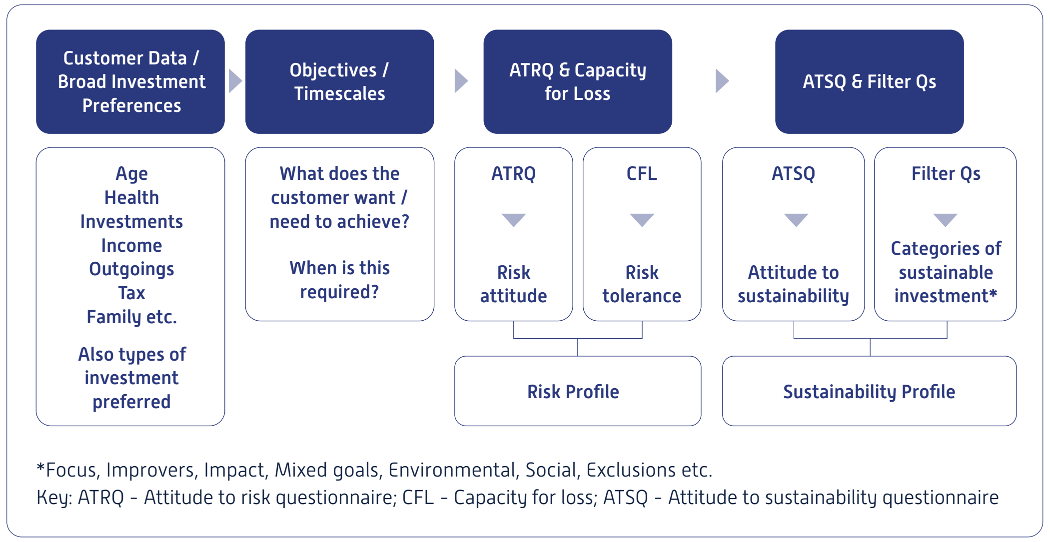
The introduction of Consumer Duty on 31 July 2023 brings the suitability assessment to the front and centre of advisers' work.

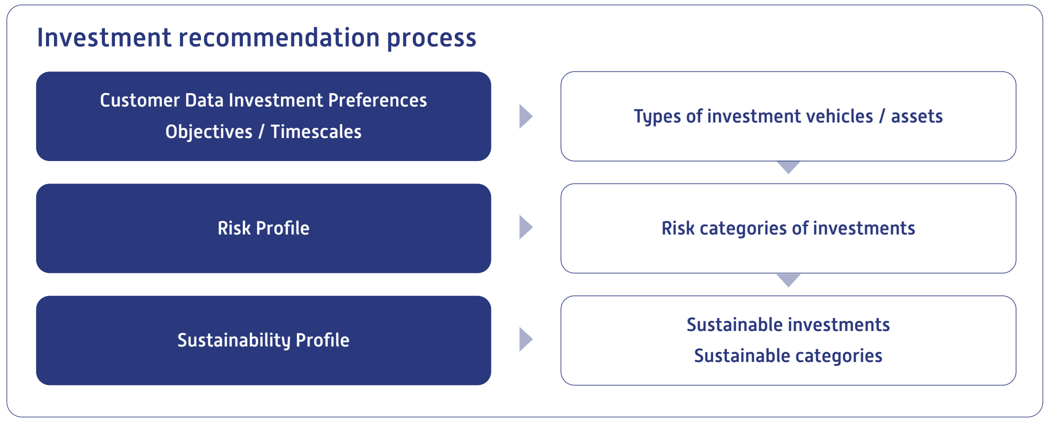
While the new rulebook does not explicitly relate to sustainable investing, it is clear that the regulator expects advisers to take all steps to ensure product suitability.

> **"Firms should:**
>
> - **Put consumers at the heart of their business and focus on delivering good outcomes for customers.**
> - **Provide products and services that are designed to meet customers' needs, that help they know provide fair value, that help customers achieve their financial objectives and which do not cause them harm.**
> - **Communicate and engage with customers so that they can make effective, timely and properly informed decisions about financial products and services and can take responsibility for their actions and decisions."**
>
> [Chapter 1 paragraph 1.9, FCA Finalised Guidance 22/5, 'Final non-Handbook Guidance for firms on the Consumer Duty', July 2022][16]

This makes it vital that advisers and other product distributors take sufficient steps to assess suitability. Sustainability attitudes are an important part of this suitability appraisal.

As the illustrations below show, the sustainability assessment can be added after the initial fact finding and risk profiling work is completed, giving an adviser a full picture of a customer's preferences and needs. This ensures a robust and repeatable process that is also demonstrable to supervisors if required.





The landscape is changing fast. Advisers can't afford to wait

As we have discussed, the regulatory landscape is still evolving.

With more regulation related to sustainable investing imminent, the time to act is now. An Attitude to Sustainability Questionnaire (ATSQ) – as part of an adviser's recommendation process – simplifies sustainable investing discussions and helps advisers design appropriate investment portfolios.

[13] Source: Financial Conduct Authority, 'CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels', consultation paper, p6. Published October 2022. Link: https://www.fca.org.uk/publication/consultation/cp22-20.pdf

[14] Source: European Securities and Markets Authority, 'ESMA published final guidelines on MiFID II suitability requirements', press release. Published 23 September 2022. Link: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-mifid-ii-suitability-requirements-0

[15] See: Financial Conduct Authority, 'CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels', consultation paper, p81. Published October 2022. Link: https://www.fca.org.uk/publication/consultation/cp22-20.pdf

[16] Source: Financial Conduct Authority, 'FG22/5 Final non-Handbook Guidance for firms on the Consumer Duty', finalised guidance paper, p4. Published July 2022. Link: https://www.fca.org.uk/publication/finalised-guidance/fg22-5.pdf