Forum Nachhaltige Geldanlagen

MiFID II requirements

ESMA Call for Evidence
on sustainability in suitability and product governance – FNG Response

Main points

1. We very much welcome the Call for Evidence - particularly on the background that there have been a lot of discussions, critique, challenges and problems with the integration of the sustainability preferences according to MiFID II. Over a year after the application of the amendment, it is time to establish where the main challenges are and take action.

2. Where we are at: a complex framework for determining sustainability preferences. Several questions asked in this Call for Evidence address specific aspects within the framework provided by MiFID II for the integration of sustainability preferences in the suitability assessment. Addressing these individual points will not solve the general problems advisors face when asking retail investors about their sustainability preferences, which arise because the current system with its three categories is too complex.

3. The direction of travel: reduce complexity to make the framework fit for purpose. Many stakeholders state that the complexities of the current system have to be reduced. What is needed is a framework which allows advisors to provide sustainable investment advice without having to explain complex concepts to retail investors. This would allow advisors to focus on the issues they want to discuss with their clients, ideally leading to greater customer satisfaction as well as more sustainable investments.

1. General remarks

Introduction

We very much welcome the Call for Evidence on the background that there have been a lot of discussions, critique, challenges and problems with the integration of the sustainability preferences according to MiFID II. Over a year after the application of the amendment, it is time to establish where the main challenges are and take action.

The FNG is the association for sustainable investments in German-speaking countries (D, AT, CH) with over 230 members. Our members include banks, investment companies, rating agencies, financial advisors, research institutions, insurance companies, NGOs and individuals. The FNG promotes information exchange and dialogue between its members – and more broadly between the market, politics, regulation and research. We have been advocating for a legal and political framework fostering sustainable investments since 2001.

Where we are at: a complex framework for determining sustainability preferences

Several questions asked in this Call for Evidence address specific aspects within the framework provided by MiFID II for the integration of sustainability preferences in the suitability assessment. Addressing these individual points will not solve the general problems advisors face when asking retail investors about their sustainability preferences.

From our perspective, these general problems are:

- Very complex framework (sustainability preferences according to Taxonomy, SFDR, PAIs) both for advisors and for retail investors

- Little to no benefit beyond legal compliance for financial advisors to ask about sustainability preferences *according to those categories*.
- No incentive or benefit for retail investors to spend time trying to understand the different categories and understanding how they relate to their general understanding of sustainability.
- Liability concerns for independent financial advisors.

At the FNG, we have been promoting sustainable investments for over two decades. Over the past years, we have closely followed and engaged in the process of integrating questions around sustainability in the advisory process. We have carried out several projects aimed at facilitating this process, such as the "Guide for integration of the sustainability preferences in the advice process", we have developed the programme "Sustainable Finance Qualification of Financial Advisors" and offer certified training courses in our FNG Akademie. We have worked with the legislation in detail and have tried to explain its complexities, however, by now we feel that the current framework is inadequate and its complexities should be reduced.

The direction of travel: reduce complexity to make the framework fit for purpose

Generally, many stakeholders state that the complexities of the current system have to be reduced. What is needed is a framework which allows advisors to provide sustainable investment advice without having to explain complex concepts to retail investors. This would allow advisors to discuss sustainability in a more accessible way with their clients and to better match their clients' preferences with available products - ideally leading to greater customer satisfaction as well as more sustainable investments.

While this is a Call for Evidence and not a Policy Consultation, we urge ESMA to analyse what works well in other areas and whether these projects and initiatives could be used in this context. A lot of work for example went into the EET (European ESG Template), it should be discussed whether this can be used to some degree in the advice process for cases where advisors want to seek more information about a product. Similarly, the insights from the development and application of the KID (Key Information Document) could be used to reduce complexities.

Don't lose sight of the overall goal

We all should bear in mind what the overarching goal of sustainable finance is: to "reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth", as was laid down in the Action Plan: Financing Sustainable Growth from 2018. Based on the experience of our advisor members, we currently do not see that the MiFID II amendment is contributing towards that goal. We welcome that some questions in the Call for Evidence might shed light on this and urge ESMA to advice the Commission accordingly if the MiFID II amendment is not contributing to this goal.

2. Responses to selected questions

Q2: Are there specific aspects of sustainable finance that retail investors struggle to understand? For example:

- Understanding of general aspects such as why it is important to consider sustainability risks and factors when investing?
- Understanding differences between sustainable products and products without sustainability features?
- Understanding that sustainability characteristics and (expected) return are two separate issues?
- **Understanding the new legal definition of "sustainability preferences" and its components (e.g., categories a),** b) and c), minimum proportion, principal adverse impact indicators (PAIs), etc)?

Regarding the points you list as examples:

From the perspective of our members, the first three points you raise are not problematic. Generally, retail investors do have a general understanding of what sustainability means. They understand the differences between sustainable and non-sustainable products and also that return is a separate issue.

The main problem advisors encounter is to put the general understanding of sustainability retail customers have into the terms, concepts and categories set by EU regulation. The main struggle for retail investors are the three categories (Taxonomy, SFDR and PAIs) provided by MiFID II for the sustainability preferences.

Further issues which are challenging:

- Not only retail investors struggle: Generally, it is not only retail investors who struggle with certain terms, concepts and categories, some problems arise already at the level of the product manufacturers and are then carried down the line by advisors to retail customers. An example are the PAIs, a lot is still unclear here and some questions retail customers might ask cannot be answered.

- Exclusions: The vast majority of clients wants to avoid certain destructive economic activities and therefore opt for exclusions. Exclusions are carried out with a tolerance level under which investment in the excluded industry is compliant with the exclusion, e.g. 5%. The rationale behind this is that for example a strict tobacco exclusion would lead to an exclusion of all supermarkets selling tobacco. A difference can also be made between prouces and distributors. Retail customers often don't understand that exclusion thresholds are necessary.
- Templates to be provided under the SFDR: Retail investors struggle to understand the templates. The language used is probably legally sensible, however, it is not fit for communication with retail investors. For example, The financial product "promotes Environmental/Social (E/S) characteristics and while it does not have as its objective a sustainable investment, it will have a minimum proportion of x% of sustainable investments with an environmental objective in economic activities that qualify as environmentally sustainable under the EU Taxonomy." is not a sentence which is easily understood even by retail investors having some knowledge in (sustainable) investments.

Q3: Are there specific financial education initiatives on sustainable finance developed by consumer associations, trade associations or other organisations and that are used by investment firms that you can bring to ESMA's attention? Please accompany your reply with any relevant background information on the initiative and/or with details on its effectiveness/usefulness.

While being critical of the complexities of the MiFID II amendment, we have been working on several projects related to the amendment. The EURENI Project is one of them.

Three members of Eurosif (FIR - France, FNG - Germany and ItaSIF - Italy) and the Austrian Society for Environment and Technology/ÖGUT (Department Green Investment) have been working on a project under the European Environment Initiative (EURENI) to educate on sustainable finance in the context of the MiFID II amendment. The objective of this project called "Sustainable Finance Qualification of Financial Advisors" is to provide financial advisors and their clients with the keys to understanding this new context.

As part of the project, an e-learning tool for financial advisors was developed, which includes five chapters covering the following topics: the EU Action Plan; the Taxonomy; the SFDR; the amendment of MiFID II; and the resulting changes for financial advice.

For each of those topics, a short video was produced that explains the regulations and how they affect financial advice. Furthermore, three videos for retail investors were produced to educate them on aspects of sustainable investments: the different recipes for sustainable finance; what's new for retail investors in MiFID II; and engagement.

The effectiveness of the project is currently assessed via feedback surveys. Early feedback suggests that the material and videos produced are helpful, however, they are only able to reduce the complexities introduced by the MiFID II amendment to a certain extent. Nevertheless, we will continue to engage with the relevant stakeholders and seek to provide information, materials and a forum for discussion for those interested in the topic.

In autumn 2023 multi-stakeholder events are planned in Germany, Austria, Italy and France about the challenges and opportunities in the context of the MiFID II amendment (including the presentation of the EURENI project results).

Q4: What is the main way firms currently provide information to retail clients about sustainable finance? For example:

- Orally during the meetings with clients
- Through educational brochures or other (paper) documents
- Through dedicated website and apps
- A combination of the above
- Other

In your opinion, are these approaches effective? Please provide details. Are retail clients satisfied with the quality of information provided?

Our members provide a combination of the above plus regular newsletters; multi channel approaches have proven to be the most effective.

Q5: What are clients' experiences/reactions to the new questionnaires including questions on "sustainability preferences"? (e.g. do they require guidance to be able to answer to the questions? Do they show interest in the topic?)

For many of our members sustainability is not a new topic, they have been working in the area for years. Similarly, many of the retail investors advised by our members have been interested in sustainable investment products for several years, the topic of sustainable investment isn't new to them. They clearly show interest in the topic.

However, even for this group of advisors and retail investors who are keen on sustainable investment and have engaged with the issue over the past years, the categories set up by MiFID II (sustainability preferences according to the Taxonomy, SFDR or PAIs) are not working. There are two main reasons for this: first, the categories are very complex and second, there is no incentive or benefit for retail investors to understand the categories. While retail investors might be interested in topics such as CO2-emissions, biodiversity and human rights, they are not interested in learning about the different EU-Regulations.

Potentially explaining (briefly) what the categories are in an advice session is a question of resources. Time spent on the explanation of EU regulation cannot be spent talking about aspects of the investment decision which in fact are relevant to the retail investor.

Q6: Are there practical examples of questions used to collect information from clients on their sustainability preferences that you can share with ESMA? (as for other parts of this CfE, respondents can opt for their input to ESMA not to be made public)

This question addresses the implementation of the existing MiFID II framework regarding the integration of sustainability preferences. From our perspective, the complexity of the existing framework is too big – this issue cannot be solved by any questionnaire implementing it.

Nevertheless and as pointed out in the general remarks, we have engaged closely with the process of the MiFID II amendment and we have carried out several related projects trying to reduce at least some complexities in the implementation process.

In July last year, we launched together with the Deutsches Netzwerk Wirtschaftsethik (DNWE) an updated version of the „Guide on Sustainability Preferences of Clients in Financial Advisory Processes (MiFID II)" (the guide is in German). The Guide was developed by a multi-stakeholder working group. The latest version includes the amendment to the Delegated Regulation 2017/565 and seeks to present it in comprehensible terms as far as possible and give practical suggestions.

Q7: Which of the sustainable investment definitions do clients most often opt for? (EU Taxonomy alignment? Sustainable investment within the meaning of SFDR? Consideration of PAI? All of them?) Please provide any statistics, where available.

This question addresses the implementation of the existing MiFID II framework regarding the integration of sustainability preferences. From our perspective, the main issue is that the complexity of the existing framework is too big. Answering this question will not help to solve the problem of complexity.

Q8: How are firms collecting information from clients on their preferences concerning the minimum proportion? With regards to the use of standardised minimum proportions, which standardised minimum proportions are presented to clients?

This question addresses the implementation of the existing MiFID II framework regarding the integration of sustainability preferences. From our perspective, the main issue is that the complexity of the existing framework is too big. Answering this question will not help to solve the problem of complexity.

Q10: Are firms currently able to satisfy the sustainability preferences expressed by clients (in particular in relation to the three categories (Taxonomy, SFDR, PAI))? If so, for which categories and/or types of financial instruments do firms find it most difficult to satisfy clients' preferences?

This question addresses the implementation of the existing MiFID II framework regarding the integration of sustainability preferences. From our perspective, the main issue is that the complexity of the existing framework is too big. Answering this question will not help to solve the problem of complexity. The three categories themselves are the main problem; the fact that only limited products are available is secondary.

We would like to point out that the complex categories together with the limited products currently available present a strong incentive for advisors to suggest to their clients to answer "no" when asked whether they have sustainability preferences – even if they do want to invest sustainably. This way, there is no need to follow the questions around the three categories, explain their meaning etc.. After taking into account the minimum proportions, it is likely that a situation arises where very few products are available, especially if the retail investor choses a high proportion. In contrast, if the retail investor opts for no sustainability preferences, advisors can ask much more freely about sustainability topics and ambitions and still recommend a sustainable financial product.

Despite this criticism, we would like to offer some background information to this question. In our Market Study (FNG Marktbericht 2023). We asked what type of characteristics funds have which are being offered under MiFID II. In 2022, the vast majority (77%) refer to both PAIs and the SFDR in Germany. The data for Austria is similar, with 82% referring to both PAIs and SFDR.

Q21: How are clients' sustainability preferences gathered on the consideration of PAIs? Do firms refer to the PAI indicators listed in Annex I of the SFDR Delegation Regulation exclusively, or may clients express their preferences based on other PAIs? If clients may express their preferences based on other PAIs: what are those PAIs and how were they identified?

This question addresses the implementation of the existing MiFID II framework regarding the integration of sustainability preferences. From our perspective, the main issue is that the complexity of the existing framework is too big. Answering this question will not help to solve the problem of complexity.

However, we would like to point out on a general level that some of our members give examples, and generally ask open questions to focus on those things that are on investors' minds. It is not the task of financial advisors to educate retail investors on all kind of sustainability matters. This would overload the consultation process and actually materialize in a competitive disadvantage against advisors who do not do that. Many of our members focus on the existing understanding of sustainability retail investors have and try to work with that.

Q22: May clients determine qualitative elements in order to demonstrate the consideration of PAIs?

- If so, what are these qualitative elements and how were they identified, how is the information on qualitative elements gathered?
- If not, what are the challenges preventing you from offering such possibility to clients? How could these challenges be overcome?

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Q28: Are firms making use of ESG rating/scoring systems for products mapping in terms of sustainability? If yes, please provide details.

Since 2012, the FNG Sustainability Profiles have provided an overview of sustainable investment strategies and relevant key data on sustainable investment funds. They are especially popular with the members who work as financial advisors and according to their feedback have proven themselves to be very valuable in their work with customers. The main goal here is to improve transparency for investors and financial advisors in the market.

The profiles not only support investors and financial advisors in obtaining an initial overview of the sustainability strategy applied to a specific fund but also allow for a comparison of different investment funds.
They include a variety of sustainability criteria and can be sorted according to personal preferences. Some of these filter criteria are sustainability approaches such as the fulfilment of Article 8 or 9 of the SFDR, as well as Impact Investing or Norm-based screening.
Moreover, the FNG Sustainability Profiles allow for a customisable exclusion of certain criteria from all three ESG components (e.g., `fossil fuels' or `corruption and bribery').

The profile itself is built as a fact sheet and can be downloaded for every fund shown on the FNG website. Next to the basic facts, the reader is provided with short explanations regarding the sustainability approach of the respective investment fund. These explanations are written by the fund providers themselves and thus allow for a presentation of the fund from the provider's point of view.

The FNG Sustainability Profiles are designed as an orientation and are not a substitute for an independent analysis. The profiles provide supplemental information and do not constitute investment advice, investment brokerage or closing brokerage. Moreover FNG Sustainability Profiles are neither a scoring nor a rating and should be used as a source of information about the fund's strategy only.

Information from the FNG Sustainability Profiles is based on self-reporting by the providers and is not corrected or verified by the FNG. The FNG's role here is to provide the platform for the presentation of the funds and update the entry form according to relevant policy changes in order to provide users with useful information.

The FNG-Label (FNG-Siegel) is also relevant in this context. The FNG-Label is the quality standard for sustainable investments on the German-speaking financial market. It was launched in 2015 after a three-year development process involving key stakeholders. The sustainability certification must be renewed annually.

Information on the FNG-Label and the stakeholders involved:

The FNG-Label is the quality standard for sustainable investment funds and similar products in German-speaking countries. The holistic methodology of the FNG-Label is based on a minimum standard. This includes transparency criteria and the consideration of labor & human rights, environmental protection, and anti-corruption as summarized in the globally recognized UN Global Compact. All holdings in the respective fund must also be fully analysed for sustainability. Investments in nuclear power, coal mining, coal-fired power generation, fracking, oil sands, tobacco production, and weapons & armaments are excluded (usually with a 5 percent revenue threshold).

High-quality sustainability funds that excel in the areas of "Institutional Credibility", "Product Standards" and "Portfolio Focus" (stock selection, engagement, and KPIs) receive up to three stars.

The FNG-Label goes far beyond a pure portfolio view and is therefore holistic and meaningful. With 111 questions, the sustainability investment style, the associated investment process, the associated ESG research capacities, and any accompanying engagement process are analyzed and evaluated. In addition, elements such as reporting, controversy monitoring, stakeholder engagement, and the fund company as such play an important role.

The more multi-layered and intensive a product's sustainability activities are on the various levels, the higher its sustainability quality and the potential to ultimately achieve indirect and direct impact.

Q35: Which percentage of products in firms' offering have sustainability features? Please provide breakdowns and details, where available. Are retail clients satisfied with the availability of products with sustainability features (number, type, characteristics)?

Many of our advisor members specialize in sustainability. Therefore, many of them only offer products with sustainability features, and often clients chose them because of this specialization.

Q36: Are firms facing specific issues related to data availability/data quality with respect to financial instruments with sustainability features? If yes, how are firms dealing with these issues?

Yes, data availability is a challenge. The main issues from our perspective are:

- All stakeholders are confronted with the fact that precise numbers can only be provided for a very limited set of criteria and many important things cannot directly and only to some degree indirectly be measured.
- Differences in methodology of measurement can affect the comparability.
- Reporting requirements for companies are only gradually coming into force.
- Data is better / more readily available for certain issues (emissions), while for others there is still some way to go (biodiversity, social issues). There is a general tendency that fairly easily measurable criteria like emissions are dominating media and perception while more complex issues are left in the shadow.
- There is legal uncertainty particularly around the use of estimates. Generally, there is a concern around accusations of greenwashing in cases where the data is not complete.

Advisors often rely on specialized platforms to get the information about products. It is too expensive for them to buy additional data from rating providers, even if they feel that they would like more information. Some fintech solutions are closing the gap here, however, with narrow margins this is not a solution for all advisors. Potential solutions could involve making better use of the EET.

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About: Forum Nachhaltige Geldanlagen - FNG
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We are a founding member of the European association Eurosif.