Regulating ESG investing the E.U. way

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CONTENTS

INVESTMENTS

8 SeLFIES: A new pension bond and currency for retirement
Robert C. Merton, Distinguished Professor of Finance, Nobel Laureate – Economics 1997, MIT Sloan School of Management
Arun S. Muralidhar, Co-founder and Client Portfolio Manager, AlphaEngine Global Investment Solutions LLC

20 Robo-advice and the future of delegated investment
Christoph Merkle, Associate Professor, Aarhus University

28 Wealth management in the age of digital assets: How financial advisors can find opportunities amongst disruption
James McDonald, Senior Consultant, Capco
Tyler Salathe, Senior Consultant, Capco

34 The E.U. alternative investment fund industry: Insights from AIFMD reporting
Antoine Bouveret, Senior Economist, European Securities and Markets Authority
Massimo Ferrari, Economist – Markets and Investors Team, European Securities and Markets Authority
Steffen Kern, Chief Economist and Head of Risk Analysis, European Securities and Markets Authority

44 Consideration on better tokenization practices and regulations concerning investor protection
Yuta Takanashi, Senior Fellow, Georgetown University
Shin’ichiro Matsuo, Research Professor, Georgetown University
John Jacobs, Executive Director, Center for Financial Markets & Policy, Georgetown University
Eric Burger, Research Professor, Georgetown University
Clare Sullivan, Visiting Professor, Georgetown Law Center, Georgetown University
James Angel, Associate Professor, Georgetown University
Tatsuya Saito, Assistant Manager, Center of FinTech, Corporate Planning Division, Mitsubishi UFJ Trust and Banking Corporation
Toshiki Hashirisaka, Senior Manager, Center of FinTech, Corporate Planning Division, Mitsubishi UFJ Trust and Banking Corporation
Hirotoshi Sato, Vice President, Digital Transformation Division, MUFG Bank, Ltd.
TECHNOLOGY

57 Digital disruption – a CEO’s survival guide
   Jet Lali, Chief Digital Officer, State Street Global Advisors

67 Applying artificial intelligence in finance and asset management: A discussion of status quo and the way forward
   Juergen Rahmel, Chief Digital Officer, HSBC Germany

75 Front office efficiency: Improving business development and increasing sales
   Ingo Rauser, Senior Partner, Switzerland, Capco
   Tobias Wehrli, Senior Consultant, Switzerland, Capco

81 Client preferences for digitization and ecosystems in wealth management
   Teodoro D. Coca, Professor, Chair for Wealth and Asset Management, University of Linz, and Adjunct Professor, Swiss Finance Institute

93 The future of asset management – a technological perspective
   Pascal R. Nägeli, Managing Partner, i.AM Innovation Lab AG

98 Transforming insurance settlements: Real-time processes through blockchain, Internet of Things, and explainable AI
   Md Mamunur Rashid, Senior Research Fellow, Consumer and Organizational Data Analytics (CODA) Research Centre, King’s College London
   Stuart J. Barnes, Chair in Marketing, Consumer and Organizational Data Analytics (CODA) Research Centre, King’s College London
   Md Abdur Rahman, Associate Professor, Department of Cyber Security and Forensic Computing, University of Prince Mugrin

ESG

115 Human capital and the future of work: Implications for investors and ESG integration
   Sakis Kotsantonis, Co-Founder and Managing Partner, KKS Advisors
   George Serafeim, Charles M. Williams Professor of Business Administration, Harvard Business School, and a Co-Founder, KKS Advisors

131 Integrating climate transition risk into investment portfolios
   Michael Lewis, Head of ESG Thematic Research, DWS Group GmbH & Co. KGaA
   Carsten Keil, Head of ESG Engine & Solutions, DWS Group GmbH & Co. KGaA

139 Shaping a sustainable economy: A bird’s eye view of the E.U.’s ESG reform project
   Caitlin McErlane, Partner, Financial Services Regulatory, Baker & McKenzie LLP

149 ESG and the duties of investment managers examined
   Daniel Nevzat, Manager, Government Relations and Public Policy Practice, Norton Rose Fulbright LLP
   Imogen Garner, Partner, Financial Services Group, and Head, Buy-side Regulatory Practice, Norton Rose Fulbright LLP

155 Greta’s expectations – we must all be stewards now!
   Eoin Murray, Head of Investment, Hermes Investment Management

163 Regulatory implications of ESG Investment
   Luke O’Leary, Associate, White & Case LLP
   Mindy Hauman, Professional Support Counsel, White & Case LLP

171 ESG investing in emerging markets
   Panos Seretis, Head of ESG Research – EMEA, MSCI
   Zoltan Nagy, Executive Director, Equity Core Research, MSCI
   Ric Marshall, Executive Director, ESG Research team, MSCI

180 Regulating ESG investing the E.U. way
   Aron Szapiro, Head of Policy Research, Morningstar
   Andy Pettit, Director of Policy Research, EMEA, Morningstar
DEAR READER,

The global wealth and asset management industry faces clear challenges, and a growing call for innovation and transformation. Increased competition, generational shifts in client demographics, and growing geopolitical uncertainty, mean that the sector needs to focus on the new technologies and practices that will position for success, at speed.

There is no doubt that technology will be at the forefront of a responsive and effective wealth and asset management sector in 2020 and beyond. The shift to digitization, in particular, will see the speeding up of regulatory protocols, customer knowledge building, and the onboarding process, all of which will vastly improve the client experience.

This edition of the Journal will focus closely on such digital disruption and evolving technological innovation. You will also find papers that examine human capital practices and new ways of working, regulatory trends, and what sustainability and responsible investment can look like via environmental, social and corporate governance.

As ever, I hope you find the latest edition of the Capco Journal to be engaging and informative. We have contributions from a range of world-class experts across industry and academia, including renowned Nobel Laureate, Robert C. Merton. We continue to strive to include the very best expertise, independent thinking and strategic insight for a future-focused financial services sector.

Thank you to all our contributors and thank you for reading.

Lance Levy, Capco CEO
REGULATING ESG
INVESTING THE E.U. WAY

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ABSTRACT
The publication of a Sustainable Finance Action Plan in March 2018 marked the European Commission’s formal launch of a major project to leverage financial markets to address sustainability challenges. The Commission had previously identified an annual funding gap of between €175 billion and €290 billion to meet its envisaged target of a 50 percent cut in greenhouse gas emissions by 2030. To plug the gap, the broad series of steps set out in the Action Plan ultimately seeks to induce behavioral change to reorient capital flows and mainstream sustainability in risk management. In this paper, we examine how the plan uses traditional regulatory tools to achieve these goals, and the challenges and opportunities in doing so. We find that changing fiduciary and suitability standards are the most coercive tactics, but enforcement and implementation will determine the degree to which these approaches cause the investment industry to consider and cater to investors’ ESG preferences. Further, new disclosure regulations will have a profound impact on the information investors have and, if they are enforced and effective, make it much easier for them to express their sustainability preferences through their investments.

1. INTRODUCTION
A hundred and ninety-six countries, and the E.U. itself, are now signatories to the 2015 Paris Agreement on climate. The governments of many of those countries are increasingly turning to their financial services sectors to help fulfill the commitments they have signed up to.

To put some context around the scale of the task, the E.U. estimates a yearly investment gap of between €175 billion and €290 billion to meet its envisaged target of a 50 percent cut in GHG (greenhouse gas) emissions by 2030 and to be climate-neutral by 2050.3

In turn, the E.U. has started a major project to leverage financial markets to address sustainability challenges – particularly global warming – complete with new legislation and directives that are in various phases of development.

2. THE EUROPEAN COMMISSION’S (E.C.) SUSTAINABLE FINANCE ACTION PLAN
The E.U.’s efforts are guided by the Sustainable Finance Action Plan, the E.C.’s proposed package of new laws and regulations that aims to elevate the environmental and social sustainability of an enterprise as a key factor for investors. Political agreement and much of the legislative text was largely complete by late 2019, with work on the detailed implementing measures continuing through 2020.4

Without question, this is a massive shift in the way governments have thought about the need to regulate capital markets. Traditionally, financial regulators have focused on protecting investors at least from fraud (and increasingly from substandard or conflicted advice), ensuring that financial markets are transparent, trading is fair, and avoiding systematically important failures or liquidity crises. The

1 Note: In this paper, we do not consider some of the proposals that affect bank or most insurance regulations. Rather, we choose to focus on the aspects that could affect ordinary investors and how their investments are managed.
E.U.’s Sustainable Finance Action Plan represents a sharp discontinuity with those historical concerns. Instead, the E.U. plans to harness financial markets as part of a broader policymaking agenda promoting sustainability as core to economic growth and societal benefit.

Indeed, the E.U. now has three additional goals beyond the traditional regulatory concerns for financial markets, which it describes as: 1) reorienting capital flows toward a more-sustainable economy; 2) mainstreaming sustainability in risk management; and 3) fostering transparency and long-termism. In other words, the E.U. wants more investors to consider sustainability factors as they make investment decisions and to put their money in sustainable products, and by changing the investing culture, put a stronger onus on corporate CEOs to think much more long-term about the sustainability of their operations.

3. INTEREST FROM INVESTORS CONTINUES TO INCREASE

As of December 31, 2019, 2,405 sustainable funds were domiciled in Europe. Of those, 360 were launched during the year, and in that same period inflows were more than twice as high as those in 2018.5

With this growth, the share of passive investment mandates has increased to 21 percent of the European sustainable fund market, up from 14 percent five years ago.

These funds use ESG factors as a key part of their security selection and portfolio construction process, to pursue a sustainability-related theme, or to seek a measurable positive impact alongside financial returns.

This level of interest and growth trajectory is promising for those governments keen to increase the flow of funds to sustainable investments. On the flip side, it can create temptation for funds to exaggerate their “E,” “S,” or “G” credentials to attract a share of fund flows – so-called “green-washing”.

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In all cases, the E.U. intends to induce a variety of third parties to carry out a public aim.
”

Investors actively choosing a “green” product, sometimes at higher cost or with the chance of lower returns, will expect some assurance that the product really is green. The core elements of the E.U. plan suggest that regulators are alert to the challenge and are aiming to provide an environment that facilitates continued growth while protecting investors from being misled into unsuitable products.

4. POLICY APPROACHES TO MEET THE E.U.’S SUSTAINABLE INVESTING GOALS

While the E.U.’s set of goals to increase sustainable investing is new, the core approaches that the E.C. plans to take to advance the agenda are not – they are the same basic tools the E.U. has historically used to protect investors and keep markets fair.

In all cases, the E.U. intends to induce a variety of third parties to carry out a public aim. Specifically, the E.C.’s proposals for new regulations, and modifications to existing legislation, rely heavily on the traditional pillars of financial regulations: disclosures, suitability regulations, and fiduciary standards of conduct or other duties to investors (Table 1).

Table 1: The E.U. plans to leverage traditional approaches to achieve a new sustainable finance goal

<table>
<thead>
<tr>
<th>DISCLOSURES</th>
<th>SUITABILITY RULES</th>
<th>FIDUCIARY OBLIGATIONS</th>
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<tbody>
<tr>
<td>…to induce private third parties to align their investing decisions with EC suitability goals</td>
<td>…will require financial advisors to consider their clients’ interest in sustainable products as part of their recommendations</td>
<td>…will require asset managers to integrate ESG factors into their overall investment process</td>
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4 Under the EU legislative process, once the Commission adopts a proposal for a Regulation, the Parliament and Council separately consider their views before entering into triilogue negotiations. Once agreed and adopted by both institutions, the Commission will publish the text in the Official Journal, to take effect usually 12-18 months later.
5 Bioy, H., and E. Stuart, 2020, “European sustainable fund flows: a record-shattering year,” January 30, Morningstar
Table 2 highlights select legislative or non-legislative proposals that aim to advance the E.U.’s goals, along with their status. We do not include a high-level goal on fostering investment in sustainable projects that is not yet fully defined, nor prudential bank and insurance regulation, which is outside the scope for this paper.

As demonstrated in Table 2, although the E.U. is taking financial regulation in a completely new direction – actively trying to steer investments as part of a new sustainability goal – its plans rely heavily on the traditional financial regulatory approach of compelling disclosure. However, the two most coercive approaches they plan to take out of the toolkit are changing fiduciary and suitability standards. How well these approaches perform is predicated on how effective the disclosures are, particularly the extent to which they are comparable, useful, and complete. Since these regulations hinge on a public/private partnership between regulators and financial professionals, their success depends on whether the market can scale up the integration of this ESG data into capital markets and whether financial product manufacturers can deliver cost-effective green products. Furthermore, regulators in different member states will need to enforce the rules sufficiently so that the obligations do not become a check-the-box exercise, without stifling private-sector innovation.

5. UNDERSTANDING THE REGULATORY APPROACHES AND THEIR STRENGTHS AND WEAKNESSES

Every approach to correcting market failures has strengths and weaknesses that can help us predict likely future implementation challenges. In this section, we consider the degree to which each approach is likely to achieve the E.U.’s core goals, summarized in Table 3. In summary, given the heavy reliance on disclosure, the effectiveness of the action plan depends heavily on the degree to which financial advisors faithfully integrate ESG factors into their recommendations for ordinary investors; the degree to which the disclosures allow for comparability and meet investors’ needs; and the degree to which asset managers integrate ESG factors into their processes and provide products that meet investors’ needs.

6. DISCLOSURES ARE DESIGNED TO NUDGE INVESTORS

The E.C.’s regulatory approach will rely heavily on new disclosures by listed equity companies, issuers of bonds, and investors, which are advanced by five of the new investment proposals in the hope that this information will induce investors to align their investing decisions with E.C. goals of increased sustainability.
Indeed, the obligations being placed upon downstream institutional investors and financial advisors all have a significant dependency on understanding what individual companies are doing to manage ESG risks and create positive impacts. Disclosure of this information in a common language with standardized ways of measuring performance is a critical foundational requirement that underlies the development of an environmental taxonomy. “Green” bonds will be a significant factor in achieving the E.U. aims, and these also face more standardized disclosures about how each bond uses the money raised and the environmental impact that it makes.

Newly required disclosures will provide investors with a framework for sustainable activities, labels for green financial products including bonds, the incorporation of ESG factors in market indexes, clarity about the aims of low-carbon or positive-carbon benchmarks, and new corporate issuance disclosures to underpin all the other sustainable finance efforts.

Credit rating agencies have also been served new disclosure guidelines by European Securities and Markets Authority, or ESMA. The supervisory authority stopped short of mandating the consideration of ESG factors in credit rating decisions but, effective end of March 2020, they should inform whether ESG factors were a key driver of a credit rating action. Further, the E.C. is in the midst of reviewing the market structure for sustainability ratings, data, and research with results expected in late 2020.

These disclosures will provide an important foundation to enable the other aspects of the E.U. plan to work. It is not an exaggeration to say that aligning these disclosures with investor needs is essential for the other parts of the plan to effectively push investors to redirect capital toward sustainable investments. Further, they are necessary for investors to properly consider sustainability as part of their process, a key goal of the E.C. Finally, they will add new transparency if they are correctly calibrated and if disclosures across entities are comparable and useful. Nonetheless, it would be a mistake to assume the disclosures will work on their own. They are a necessary nudge, but hardly sufficient to achieve the goals of the Sustainable Finance Action Plan.

The central proposals to enhance disclosures are new Taxonomy and Disclosure Regulations.

### 6.1 Taxonomy regulation

The E.U. Taxonomy is effectively a classification tool to help investors and companies make informed investment decisions. It has been a cornerstone of the action plan to scale up investment to the most environmentally effective activities, a prerequisite of which is increased data flows across capital and commodity markets.

Initially, the Taxonomy is focused exclusively on environmental activities. An expert group identified 67 business activities across eight sectors that contribute to climate change mitigation or adaptation, without doing significant harm to four other environmental objectives that the Taxonomy will ultimately cover: water; circular economy and waste; pollution prevention and control; and the protection of healthy ecosystems.

In its first incarnation, the organizations compelled to reference the Taxonomy are the manufacturers of investment products that promote environmental or sustainable characteristics; E.U. member states that create any public labeling schemes for green investment products or corporate bonds; and, in a late amendment, large corporations.
Those corporations will now be required to disclose the proportion of their revenues that are aligned with the Taxonomy, which will help investors assess to what extent their investments contribute to environmentally friendly activities. It is an important addition that will help investors report on the proportion of investments that are Taxonomy-eligible. For example, consider a company with 80 percent of its revenue in Taxonomy-aligned activities. If half of an investor’s portfolio were in such a firm, the investor’s portfolio would be 40 percent aligned with the Taxonomy, assuming it included no other Taxonomy-aligned investments. If the remainder of the portfolio were in companies with revenues that were 50 percent aligned with the Taxonomy, then the portfolio would be 65 percent Taxonomy-aligned.

The E.C. hopes that a broad range of other market participants will voluntarily embrace the Taxonomy, such as banks in the assessment of green loans, and plans to examine how to leverage it for other financial products. However, regulators face two significant challenges: firstly, the plan’s current limited scope, and secondly, competition from other taxonomies, labels, and standards being developed within and beyond the E.U.

Despite that, these moves toward more standardized disclosures by financial products about the positive environmental objectives they contribute to, together with the methodologies used to measure and monitor progress, could play a meaningful role in minimizing levels of future greenwashing. The success of the disclosure regime will depend on the Taxonomy continuing to evolve, but also on new disclosures that are completely apart from the Taxonomy. In the next subsection, we expand on the other parts of the new disclosure regime beyond the Taxonomy, which will also be critical for providing the common language, particularly around principal adverse impacts of an investment, E.U. policymakers believe will advance the goals of the Sustainable Finance Action Plan.

6.2 Disclosure regulation

The new Disclosure Regulation supplements the current rulebooks governing manufacturers of, and advisors on, financial products. Broadly, managers must disclose how sustainability risks are considered in their investment process, what metrics they use to assess ESG factors, how they consider investment decisions that might result in negative effects on sustainability factors, and principal adverse impacts in the regulators’ jargon.

Disclosures are most useful when they are concise, standardized, and, ideally, quantified and forward-looking. The preamble of the Regulation acknowledges that divergent and non-harmonized disclosure standards create an uneven playing field for products and can confuse investors and distort their investment decisions. How effectively these goals are transposed into practice will emerge later in 2020, in the form of the Delegated Acts and Regulatory Technical Standards, which will define how the Regulation is implemented. These developments will be critical in shaping how effective the Disclosure Regulation will prove to be.

One promising way to operationalize a sustainability suitability score is to illustrate potential trade-offs.

A prerequisite for products promoting ESG characteristics will be to explain how they plan to achieve their aims and provide supporting indicators, including, where relevant, its ESG benchmark and a broad market benchmark. They will also need to assess and report on sustainability-related risks and their potential negative effects on the financial returns of the product.

This escalating universe of investable ESG products can reasonably be expected to presage an ever-increasing creation of benchmark indexes; the many broad market benchmarks are likely to be supplemented with more-focused versions that track markets through different policy lenses. Reflective of the broad reach of the E.U.’s plan, providers of such benchmarks also face major new disclosure obligations.

Firstly, to assuage concerns about the wide variety of carbon benchmarks being used by investment portfolios, two categories of carbon benchmark are being defined in regulation. Carbon benchmarks must be either E.U. Climate Transition or the more aggressive E.U. Paris-Aligned, and to use either label providers must describe how the constituents were selected and why others were excluded.

Secondly, benchmark administrators will have to disclose in all of their benchmark statements, except those of interest rate or foreign-exchange-rate benchmarks, whether ESG objectives are pursued.
A big unknown for the investors hoping to benefit from these new disclosure obligations is the degree of consistency and comparability to expect. The different implementation times will compound the challenge, with even the first components of the Taxonomy not taking effect until 2022, while the Disclosure obligations for ESG fund managers kick in earlier in March 2021 and for benchmark providers in April 2020. Thus, until the Taxonomy is live, and corporations are reporting revenue breakdowns accordingly, benchmarks and funds are being handed a reporting challenge that will likely require them to develop estimation models to measure their constituents’ level of Taxonomy-eligibility. As a result, it will almost certainly hinder comparability in the early stages but potentially allow best practices to gradually emerge and gain adoption. On balance, we support this progressive approach as preferable to waiting for a distant date for all parties to comply. The shorter the time period in which a reasonable degree of useful standardized disclosures can be achieved, the better for all concerned.

7. COERCING ADVISORS AND INVESTORS THROUGH SUITABILITY RULES

Suitability fact-finds are a core (and legally required under Markets in Financial Instruments Directive or MiFID) first step in advisors getting to know their clients and form part of their suitability assessment.

Traditionally, these efforts have meant that advisors considered factors such as time horizon, investing objectives, and risk tolerance as they make their recommendations to clients. Under the proposal, financial advisors will need to further consider their clients’ interest in sustainable products as part of their recommendations.

These suitability standards are much more coercive than the new disclosures and can help direct capital flows to new investments — if investors respond to them. Designing a mechanism to operationalize a sustainability preference will be challenging, since sustainability encompasses a wide range of activities, while other suitability factors, such as capacity for loss and knowledge and experience, are more linear and easily quantifiable. Furthermore, incorporating the suitability preferences hinges on adequate, accurate, and comparable disclosures.

Since so much depends on suitability, it will be critical for the E.U. and ESMA to ensure that the industry has the guidance and tools it needs to address a variety of challenges as they implement the suitability requirement.

First, there are a wide variety of definitions of ESG, so an advisor and investor could talk about ESG preferences without ever actually understanding each other. For example, each could mean negative screens, best in class and impact, or some other more granular concern. Particularly in the early stages, when the Taxonomy is not fully developed, this wide variety of definitions, preferences, and goals for investors will make it challenging to ensure an investor’s sustainability preferences match up with a particular investment. Even as the Taxonomy is fully developed, it provides definitions of positive activities that contribute to sustainability. Some investors may be more focused on sustainability risk, an activity they do not want to support with their investments, or activities that are not defined in the taxonomy. Aligning a suitable investment to this wide variety of ESG interests will prove challenging. Investment advisors will need robust data on the universe of investments and clear guidelines on how to cope with this wide variation in sustainable preferences. Ensuring advisors and investors understand the differences in preferences between avoiding ESG risks, making sustainable impact investments, or avoiding certain types of companies, industries, or products will be critical.

Second, it is difficult to operationalize for consistency of preferences for investors interested in incorporating ESG factors into their investments. For example, simply asking people whether they value sustainability is likely to result in inconsistent answers that do not reflect revealed preferences. One promising way to operationalize a sustainability suitability score is to illustrate potential trade-offs, and we have tested this approach successfully. However, using a trade-off-based approach to elicit how important sustainability is to an investor leads to another problem: advisors will need to clearly convey to investors that they may not be sacrificing returns by virtue of picking sustainable products. Further, sustainability should not be used as an excuse for poorly performing or high-cost investment products. There will inevitably be a transition period during which regulators monitor how firms experiment with ascertaining investors’ preferences and how to communicate the actual potential trade-offs of various sustainable strategies, while using a principles-based approach.

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2 Ibid.
Finally, we believe that portfolio-level analysis is critical to allow investors to see how their portfolios perform in terms of performance on ESG metrics. After all, most investors will not want a portfolio solely devoted to a specific ESG goal, or perhaps fully devoted to any sustainability goal. If an investor has moderate preference for sustainability, their portfolio should tilt toward moderate sustainability. Draft ESMA guidance would allow advisors to either direct a portfolio toward various ESG investments at the percentage levels clients specify, or to examine a portfolio and decide on the degree to which it meets an investor’s sustainability goals. Eventually, if the Sustainable Finance Action Plan works as intended advisors may be highlighting remaining “brown” investments in a portfolio and assessing the suitability of those investments, rather than looking for green investments. The next section explains how a new fiduciary focus on ESG factors rounds out the Sustainable Finance Action Plan.

8. FIDUCIARY OBLIGATIONS DIRECTING CHANGES IN ASSET MANAGERS’ PROCESSES

Asset managers and financial advisors in the E.U. often have a fiduciary obligation to their investors (depending on the investment product they manufacture), meaning that they have duties to act in the best interest of end investors and conduct adequate due diligence prior to making investments.

The E.U. is explicitly incorporating ESG considerations into these fiduciary obligations. It is both a coercive and pragmatic step. Coercive in that it forces ESG factors to be a part of investment analysis, and pragmatic in that it will eliminate claims of failure of fiduciary duties in instances where ESG is not considered but becomes financially material.

Operationally, the expanded considerations will be executed via amendments to the suite of existing directives that cover the investment fund and insurance-linked investments sector, namely UCITS (Undertakings for the Collective Investment in Transferable Securities), AIFMD (Alternative Investment Fund Managers Directive), Solvency II, MiFID II, and IDD (Insurance Distribution Directive). The drafted amendments will require investment managers to integrate all relevant financial risks into their overall investment and due-diligence processes, but also include all relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment.

Informing investors that these sustainability factors are being considered, and how so, is mandated by the aforementioned Disclosure Regulation. When the sustainability risk assessment leads to the conclusion that there are no sustainability risks deemed to be relevant to the financial product, the reasons should be explained. When risks are identified, the extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms.

Beyond posting these policies on their websites, products that promote ESG characteristics will have to report in their pre-contractual disclosures on what that really means and how they enact their investments and benchmark them.
Additionally, and somewhat separate from the Sustainable Finance Action Plan’s package of measures, the Shareholder Rights Directive II requires investment managers to disclose more about how they engage with the firms in which they invest and steward their investors’ assets.

Already, many fund prospectuses say they include sustainability factors, but it is not clear to what degree they do so. Should this approach work, it would both aid the identification of the best ESG products and minimize greenwashing. To make it work, firms will have to apply pressure to get the company disclosures they need, which could force public companies to consider sustainability in order to continue to be attractive investments.

9. CONCLUSION

Policymakers have set out their stall to make Europe the first climate-neutral continent by 2050 and appointed the financial services industry a key participant in achieving it. The intervening years will continue to see much iterative development across all strands of the Sustainable Finance Action Plan – from risk assessment, through investment selection and reporting, to research, data, and ratings services.

Its success will depend in part on the degree of enforcement of the rules by the E.U. and member states, how it translates into a range of cost-effective greener products, and the ability of the market to scale up the integration of ESG data into capital. During 2020, it will start to become clearer how prescriptive the implementing rules of the different components will be.

The disclosure requirements can provide an important nudge to investors. Furthermore, the Taxonomy will eventually provide a mechanism to substantiate qualitative disclosures with quantitative metrics and diminish the risks of greenwashing. The more consistent the additional disclosures are, the more successful the other components of the action plan will be.

The suitability rules, imposing requirements on financial advisors to consider clients’ ESG preferences, create challenges and opportunities for advisors. The wide range of activities that fall under the ESG banner means that a top-down approach, talking about ESG in general terms, will yield more engagement with clients. That engagement will be key to combining clients’ financial and sustainability goals into investment recommendations that match investor’s preferences. Ultimately, matching investors to suitable products will hinge on adequate, accurate, and comparable disclosures by product manufacturers. Nonetheless, if advisors can clearly explain the differences between meeting specific preferences, reducing risk, or making investments in sustainable activities, this approach could help achieve key E.U. goals and nudge a growing number of ordinary investors to choose sustainable products.

The fiduciary requirements that funds consider sustainability (or explain why they do not) will be effective only if asset managers have access to high-quality ESG data from issuers, which is why the disclosure component is so critical. Nonetheless, as we monitor these changes, we should keep in mind that the European investment market has long been criticized for its high number of funds and share classes that limit economies of scale in comparison with the U.S. Other regulations, notably MiFID II and PRIIPs (Packaged Retail and Insurance-based Investment Products Regulation), have successfully exerted downward pressure on, and more disclosure of, costs and it would be a retrograde step were this to be unintentionally reversed. The hope is that the new regulations will not spur the creation of new funds that do not meet investors’ needs. Rather, if implemented properly, the new regulations should spur existing funds to fully integrate sustainability into their processes, investors to pay more attention to existing sustainability funds, and new products to meet a genuine need with clear and clearly explained sustainability goals at reasonable cost.
ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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