WealthBriefing

ESG Enters Client Suitability Menu Under MiFID II – How This Affects Advisors

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There's a lack of clarity – so far – on whether UK advisors will be affected by the adjustment to MiFID II rules on suitability. Regardless, ESG ideas continue to permeate the wealth management value chain.

European Union rules guiding advisors on the kind of investment services that suit clients must now include ESG ideas. But it is unclear to what extent these changes affect UK-based advisors after Brexit.

In August, a change to the Markets in Financial Instruments Directive II (MiFID II) required investment advisors and portfolio managers to incorporate clients' sustainability (or ESG) preferences into their suitability assessments.

The question is how much time and information is needed to make this added requirement work. Without technology to ease the process, it could add a fresh compliance burden on an already-stretched industry.

The UK is now out of the EU – raising the question of whether legislation derived from the EU still holds sway. This publication understands, however, that changes to the European Union's version of MiFID II aren't reflected in the UK version of these rules, at least at the moment. As the UK tries to keep the City competitive versus European financial hubs, it might not be keen to layer further requirements onto financial advisors and wealth managers.

The EU's sustainability move is another example of how ESG is injected into the wealth management value chain. With controversies about skyrocketing energy costs and "greenwashing," it is easy to see why policymakers think the topic should be on the investment menu.

"It is a huge challenge," Agnès Lossi, a partner at Indefi, a strategy advisor for the global investment industry, told this publication. Her firm is based in Paris and New York.

Advisors are having to spend time and resources figuring out how to integrate ESG ideas into the menus of what sort of investments and financial services suit clients, she said.

The MiFID II changes will boost the need for high-quality, easy-to-find data that advisors can put in front of clients, she said. "The development will particularly boost the need for specific products or tailored portfolios that will match ESG preferences. This is broadly not the case today," she added.

Asked if the new requirements make the advisory process even more complex, Lossi agreed that it can do so and may, ironically, increase risks in some cases. Even so, the direction of travel is clearly set and ESG is a big trend in modern wealth management.

"Many clients, such as the younger ones, want it [ESG investing]," she said. "Everything is linked to transparency…for me, this is the big issue."

First outlined by the European Securities Market Authority (ESMA) in 2021, the new rules apply to all forms of investment advice as well as portfolio management.

Q3 has brought major changes to MiFID II and the client suitability process. Indefi, a Paris-based leading strategy advisor for the global investment management business, has been having active discussions with asset management clients about how to adapt to sustainability preferences. The firm sees a few ways where this will change the competitive landscape for asset managers and distributors.

Because advisors are now required to educate, provide pre-contractual documentation, and assess client suitability, additional preparation is needed before selling products to clients. Asset managers who can get ahead of this work, and create off-the-shelf products and processes, can save time for distributors and offer them value. Some of the ways in which they can achieve this are:

-- Providing marketing materials, documentation, and suitability assessments to distributors;

-- The new jargon-filled paperwork will need to be presented to clients in a digestible manner; and

-- Asset managers may try to align assessments with their thinking to sell their products.

Increased fear of greenwashing will push distributors to rely on asset managers to do the work of sorting through the intricacies of sustainability for them.

To manage the individualised preference framework effectively, asset managers will need to liaise with distributors to service specific product needs.