ESG – Key Considerations for advisers

This handout links to our podcast regarding client conversations about ESG. Clients are increasingly interested in discussing sustainability issues and whether and how they can incorporate Environmental, Social and Governance (ESG) elements into their investment portfolio. Below we outline some of the key considerations advisers should be aware of when discussing ESG matters with clients.

1. Understanding ESG

It is key that advisers have clarity on their understanding of ESG and the jargon surrounding it.

Environmental, Social and Governance is a description of three broad non-financial factors which characterise a sustainable investment. It indicates that the product takes these factors into account although the extent to which any individual investment does consider such factors can vary significantly. What clients mean by ESG or sustainability can also vary, and there is a significant amount of jargon associated with ESG investing. For an explanation of key terms please see our ESG glossary. It is important that advisers are clear with clients about the extent of any sustainability elements of any investment under consideration.

2. Understanding client preferences

Beyond a good understanding of ESG itself, advisers need to understand client preferences in this area. Clients are individuals and will have their own views and priorities on ESG matters. It is important that advisers draw out which elements of ESG appeal to clients. It may well be that certain clients are purely focused on climate issues, whereas others are more concerned about social issues, such as modern slavery issues etc.

Questions to consider asking clients include:

- What level of investment return would you be prepared to potentially risk missing out on in order to incorporate ESG compliant stocks?
- If you had to choose would you prefer to invest in a company that paid special attention to governance and human rights or one which invested heavily in reducing their carbon footprint?

It is also important to note that how the ESG elements of any investment are implemented. Does the product have a screening element, or is a percentage element used? Is it linked to an ESG rating or index? Does the client understand how the ESG element of the investment is implemented and monitored and what, if any, effect it may have on investment returns?

In relation to EU investments, advisers are obliged to collect client sustainability preferences from clients, the EU has amended MiFID 2 to capture this and the FCA heavily flagged that this is the direction of travel in the UK in its SDR discussion paper and expects to work on this with the government during 2022/2023.

Advisers should expect to be able to demonstrate that they have taken account of client preferences and taken appropriate steps to ensure that clients understand the ESG element of the investment, how it is implemented and any effect on investment returns. Advisers should keep thorough client records on ESG and sustainability discussions.

3. Understanding ESG disclosures and data issues – drilling into the detail

For information on ESG disclosure obligations please see our guide. Certain obligations are already in place, for example, in the UK a large asset manager is obliged to prepare ESG disclosures with the first publication due in July 2023. Advisers need to understand these disclosures to assist discussions with clients. The FCA's developing Sustainability Disclosure Regime will likely include three levels of disclosure from consumer labels to detailed granular disclosure. Again, this is an area where advisers may need to assist clients so that they understand disclosures fully. In certain instances, such as where a firm provides discretionary portfolio management, disclosures must be provided "on-demand" and an adviser may need to request such information on behalf of a client.

Advisers should also be aware that as this is an evolving area, there are issues with the completeness and availability of data, so that firms are not always able to meet all of their disclosure obligations.

Advisers should ensure that they are comfortable with the disclosures and discuss what they mean with clients. Advisers should allow time to discuss any ESG disclosures in any annual review.

4. Greenwashing

Greenwashing is the marketing of a product, activity or policy by a firm as producing positive environmental outcomes when this is not the case.

The FCA has noted that greenwashing is an issue of concern and advisers should be aware that any strengthened regulatory focus on ESG issues may go hand in hand with an increase in claims by individual consumers who believe that they have been misled as to the credentials of particular investment products. Complaints to the Financial Ombudsman Service are also likely to increase and investors may even bring litigation claims against firms for misrepresentation or misselling products labelled as "ESG".

In order to protect themselves and their clients, advisers need to understand the products that they are advising clients on, and this includes ESG aspects of the products and associated disclosures. Ensuring that any discussions are clearly noted and evidenced is essential for advisers.

5. Incoming Consumer Duty

It is worth noting the incoming new Consumer Duty, which is due to be implemented in 2023. For any adviser with retail clients this change will be relevant as the FCA is clear that it extends the regulatory duty on firms beyond the current Principle 6 obligation to pay due regard to the interests of its customers and treat them fairly. As part of the Consumer Duty " A firm must act to deliver good outcomes for retail customers". Good communication and record keeping on behalf of firms will be key to allow them to demonstrate that they have met their obligations.