Swiss Sustainable Finance

EY

Practitioners' Guide on the Integration of Sustainability Preferences into the Advisory Process for Private Clients

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I.

Preface

1 Introduction, scope and aim of this Practitioners' Guide

In recent years, Swiss financial institutions have observed a significantly increased demand for sustainable financial instruments. According to the Swiss Sustainable Investment Market Study 2022, jointly prepared by Swiss Sustainable Finance (SSF) and the Center for Sustainable Finance and Private Wealth at the University of Zurich, sustainable investments[1] have been subject to a double-digit growth for many years. To date, sustainable funds represent 53% of the overall Swiss fund market.[2] This success story also increases the risk that investors and clients will be consciously or unconsciously misled about the sustainability characteristics of financial instruments and services, which can result in an expectation gap or so-called "greenwashing".

To address this issue, and in reaction to SSF member requests around practical implementation, SSF decided in summer 2021 to develop recommendations that provide guidance to practitioners on how sustainability preferences of clients can best be integrated in advisory processes ("Practitioners' Guide on the Integration of Sustainability Preferences into the Advisory Process for Private Clients"; hereinafter "Practitioners' Guide"). The project relied on the support of the Focus Group "Client Advisory", a subgroup of the Sustainable Investment (SI) in Wealth & Asset Management Workgroup and was managed and supported by EY. The resulting recommendations are based on a broad non-public survey of SSF members, as well as a series of interviews and workshops with members of this Focus Group conducted in Q4 2021 and Q2 2022.

In scope of the Practitioners' Guide are financial institutions providing investment advice and individual portfolio management to private clients. It is intended to provide implementation support to practitioners on an operational level by referring to best practice considerations. It does not address legal experts and does not cover regulatory obligations on a national or international[3] level, which financial institutions must comply with vis-à-vis their clients and the supervisory authority, or the obligations resulting from financial services and product regulations (e.g. Financial Services Act / "FinSA", Collective Investment Schemes Act, other binding obligations / regulations, cross-border services). This would go beyond the scope of the provided recommendations. Accordingly, this Practitioners' Guide does not discharge financial institutions from any of their legal obligations.

1 Please note this term relates to the definition of "sustainable investments" as described in the Swiss Sustainable Investment Market Study 2022.
2 Swiss Sustainable Investment Market Study 2022, p. 6.
3 Regarding EU regulation, the amendments to MiFID II define further requirements on how to integrate the consideration of sustainability factors, risks and preferences into certain organisational requirements and operational conditions for investment firms. Financial institutions should analyse the potential applicability of this regulation if they have exposure to clients in the EU.

2 Reference to Swiss (self-)regulatory environment

This Practitioners' Guide provides practical guidance of non-binding nature. It is applicable on a voluntary basis and aims to offer guidance with a set of recommendations to financial institutions intending to strengthen their private client advisory process.

There are no explicit provisions referring to sustainability preferences or sustainable investments in Swiss regulation (i.e. FinSA), but there are various relevant sources to be noted. In its *Guidance 05/2021*[4] FINMA highlights that the advisory process poses – at the point of sale – an increased risk of greenwashing if sustainability-related financial instruments are offered. According to FINMA, financial service providers should mitigate these risks. However, the competence lies with the Federal Government to introduce binding legislation, by for instance amending FinSA. Against this background, the Federal Council has instructed the Federal Department of Finance (FDF) on 17 November 2021, to come up with a proposal, in cooperation with the Federal Department of the Environment, Transport, Energy and Communications (DETEC) and FINMA, to be delivered by the end of 2022 on how financial market legislation could be amended – particularly with regard to transparency – in order to avoid greenwashing. SBA decided at the end of 2021 to further develop their SBA Guidelines and has issued the *Guidelines for the financial service providers on the integration of ESG-preferences and ESG-risks into investment advice and portfolio management* in June 2022.

The joint AMAS/SSF recommendations *How to Avoid the Greenwashing Trap* of 1 December 2021 focus both on the financial instruments designed by the fund and asset management industry and sold by financial institutions to investors as well as on the "point of sale" and distribution, thereby ensuring a financial advisor has access to relevant information in order to recommend the most suitable sustainable product to a client. These recommendations have been jointly developed to ensure that the key sustainability features of a financial instrument are presented to clients in a transparent manner and in a clear and understandable way in order to avoid the "greenwashing trap".

In addition, *Sustainable Asset Management: Key Messages and Recommendation of SFAMA* (today AMAS) *and SSF* of 16 June 2020 is a noteworthy publication.

4 FINMA Guidance 05/2021 of 3 November 2021.

II.

Practitioners' Guide

The following recommendations address financial institutions that advise private clients. Within the financial institution, these recommendations are relevant for many different functions, especially client advisors and any client facing staff (e.g. specialist advisors) and staff in support functions like e.g. training specialists as well as any other function working on designing, upgrading and implementing the client advisory process.

For the following sections, please note that the use of the word "should" denotes recommendations by SSF whereas the word "could" illustrates potential implementation solutions and best practice examples.

The guide is categorised into five key areas linked to the client advisory process: 1) Client onboarding process, 2) Knowledgeable client advisors as a prerequisite for complying with information duties towards clients, 3) Ensuring that clients suitability preferences are matched with the financial instrument as well as service offering, 4) Regular monitoring of product compliance and performance, as well as 5) Frequency and content of client reporting.

1 Client onboarding process

1.1. Determine the client's sustainability preferences

Client onboarding and the ongoing due diligence process may involve multiple tasks, including the requirement to determine the client's risk profile. If the client's investment objectives need to be determined (i.e. in case of providing portfolio management or investment advice with a portfolio approach), the client's sustainability preferences should also be obtained.

The generic question whether a client is interested in sustainability should serve as starting point to determine his or her sustainability preferences. The result of the assessment could be recorded by at least, classifying clients into simple buckets (e.g. very interested, interested and not interested).

If a client has shown interest in sustainability, a further enquiry should take place aimed at achieving a more granular understanding of the client's sustainability preferences. Accordingly, clients should be guided based on an easily understandable narrative that allows the identification of their individual sustainability preferences. The following approaches could be used:

- asking about the motivation of the client (financial performance, values alignment, positive change)[5] or
- using the SDGs to identify particular areas of interest or
- asking open questions (e.g. what does sustainability mean to you?) or
- asking questions stipulated by foreign law (e.g. MiFID II)

in order to identify a client's individual sustainability preferences.

5 See also AMAS/SSF recommendations of 1 December 2021: https://www.sustainablefinance.ch/upload/cms/user/Recommendations-forSustainableInvestmentProducts_AMAS_SSF.pdf

However, as a matter of principle, the level of detail of client's sustainability preferences for sustainable investing should reflect the financial services providers' ability to systematically ensure that such preferences can be matched with suitable financial instruments and services. In addition, potential limitations to an implementation in practice should be disclosed to clients. This will help clients form realistic expectations about what they can expect (so called "legitimate client expectations").

In the context of discretionary portfolio management, obtaining client sustainability preferences should be seamlessly integrated into the process when investment objectives and general restrictions are determined. In advisory constellations the client's sustainability preferences could alternatively be captured ad-hoc in a point of advice situation.

1.2. Documentation of the client's sustainability preferences

The client's sustainability preferences – or the lack of a specific interest in sustainability matters – should be documented, (i.e., client is (very) interested / not interested in sustainability matters) independent of whether specific sustainability preferences have been expressed by the client.

If specific sustainability preferences have been expressed, documentation should be more extensive. The following approaches could be applied:

- binding and implementable client instructions (e.g. values-based exclusions),
- expressed sustainability preferences (e.g. specific topics of interest or the request to have positive measurable impact) and
- applicable levels (e.g. high, medium or low amount) or minimum percentages (e.g. based on requirements for MiFID clients) of sustainable investments.

The documentation should adequately reflect the content of the conversation held with the client. As a result, the granularity of the documented information could be adapted to the level of interest in sustainability matters as well as to the client's level of sustainability and sustainable investment literacy.

In addition, the documentation could also make reference to the type of matching mechanism applied, e.g. on classifications of financial instruments by manufacturers or based on internal sustainability definitions (see section 3).

2 Knowledgeable client advisors as a prerequisite for complying with information duties towards clients

2.1. Client advisor education

Client advisors should be adequately knowledgeable on sustainability, sustainable investments and the applicable ESG approaches. In addition, they should be well informed with regard to the service and product offering ("offer on shelf") as well as the applicable processes of the own financial institution and thus, should be educated accordingly.[6] Their understanding and prudent approach when selling sustainable investments is crucial to avoid expectation gaps between sustainability preferences of clients and the respective implementation of the financial institutions.

The following topics should be part of the training program:

- Basics of sustainability, including different sustainability risks, e.g. climate risks
- High-level overview of international policy foundations, e.g. UN Sustainable Development Goals (SDGs), EU Action Plan on Sustainable Finance including related regulations
- Aims of the Paris Agreement and a basic understanding of required transformation pathways to a net zero world
- Sound understanding of ESG approaches applied in the investment process related to the financial instruments and services offered to clients
- Sound understanding of how (own) financial instruments and services can match sustainability preferences of clients (financial performance, values alignment, positive change), the intended ESG effect of an investment and what the respective limitations or potential negative effects can be
- ESG performance of own financial institution
- Basic "dos and don'ts" to avoid greenwashing

Depending on the range and complexity of the product and service offering of the financial institutions as well as the client base of the respective client advisor (e.g. EU clients) the following aspects could also be covered in a training program:

- Further insights into relevant SDGs, especially if used as narrative in client conversations
- Transparency required under SFDR[7] and EU Taxonomy[8] referring also to key elements like sustainability risk integration, the definition of sustainable investments according to SFDR, the principal adverse sustainability impacts and the do no significant harm principle.
- Any type of broader sustainability education or training (e.g. as described in the SSF report *Sustainability in financial education and training in Switzerland* of 25 June 2020)

6 Education can be obtained namely via the following training resources by SSF and SAQ: i) SSF education page: https://www.sustainablefinance.ch/en/education-_content---1--1081.html, ii) SSF page on Evrlearn: https://www.evrlearn.ch/corporate/z1ojUTJkk137H6QvsRWhcYa5?selected_top_category=325 and iii) SAQ education page: https://saq.ch/en/personnel-certifications/customer-advisor-bank/

7 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

8 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

2.2. Client information

Basic information on ESG approaches, including their expected benefits and limitations, how they can be invested in through the available offering of financial instruments and services, should be provided to all clients receiving advice or discretionary services who have expressed sustainability preferences.

Clients should be informed about the range of relevant sustainable investment solutions based on their sustainability preferences. Such information should be provided in a true, fair, easy to understand and non-misleading manner, which could e.g. include information about sustainability risks as well as honest information of what can be achieved with regard to real-world impacts and how a contribution to a positive change in the environment and society can be achieved. Solution-specific information should be provided to clients who expressed concrete sustainability preferences. Client advisors could limit their information to solutions that reflect stated preferences (e.g. providing information about financial instruments that refer to Paris-aligned or climate transition benchmarks to a client who has expressed particular interest in the climate topic).

"Sustainable", "ESG", "green", "SDGs", "carbon reduction", "Paris-aligned", "climate transition", "impact" and other key terms may raise client expectations regarding positive ESG effects. Special care should be applied if those key terms are used. Each financial institution should have a prudent definition of key terms and, in addition, ensure that these key terms are used consistently, both inside and outside vis-à-vis clients and that minimal standards are applied.

It is essential that financial institutions disclose their definition(s) of "sustainable investment" to clients who have shown interest in sustainable investment solutions. The definition could be referenced to e.g. a prudent internal definition or rather to existing regulations (e.g. based on AMAS/SSF recommendations or based on SFDR[9]).

Please note that the following non-exhaustive examples bear a certain greenwashing risk if marketed as sustainable (if applied standalone without the combination of other ESG approaches):

- Exclusion approaches focusing only on widespread exclusions ("controversial weapons", "tobacco", etc.)
- ESG integration and best-in-class approach purely focusing on financial materiality and not excluding a significant amount of low ESG performing assets (e.g. Art. 6 SFDR products)
- Portfolios that do not include a significant share of investments that are aligned with the sustainable investment strategy
- Voting-only, especially if purely based on governance criteria (i.e. not on environmental or social matters)
- Engagement-only, without measuring progress and escalation procedures

The joint key messages and recommendations of SSF and SFAMA (today AMAS) for sustainable asset management of 16 June 2020 and following joint recommendations on transparency and minimum requirements for sustainable investment approaches and products of 1 December 2021 as well as the FINMA Guidance 05/2021 of 3 November 2021 (greenwashing) provide guidance with further useful examples. In its supervisory practice, FINMA refers to the joint recommendations of SSF and AMAS especially regarding the implementation of sustainability approaches.

9 Art. 2 (17) SFDR: «'sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance».

Further transparency should also be provided on how different ESG approaches are applied. This could include information about:

- key information elements for each ESG approach as described in the joint AMAS/SSF recommendations on *How to Avoid the Greenwashing Trap: Recommendation on Transparency and Minimum Requirements for Sustainable Investment Approaches and Products* of 1 December 2021
- concrete exclusions applied
- percentage of a benchmark not considered investable based on exclusion or best-in-class approaches
- minimum ratings applied in best-in-class approaches as well as percentage of reduced product universe
- extent to which the inclusion of ESG factors is binding for ESG Integration approaches
- engagement and voting practices applied (e.g. publication of the voting rights policy)
- percentage of the portfolio that can be allocated to the themes or SDGs based on a thematic investment approach
- clear intentionality to have a real-world positive impact and respective evidence, in case positive ESG effects are being advertised[10]
- key performance indicators (KPIs) illustrating the actual impact achieved in the case of an impact investing approach
- average share of portfolio screened for ESG criteria
- data sources used and data quality per asset classes

Client advisors should guide clients based on the available product and service offering. They could also consider integrating third party financial instruments that complement own offerings to better match the sustainability preferences of clients.

Interested clients should also be asked about their understanding regarding sustainable investment solutions. If they are asked about their sustainability and sustainable investment literacy this could be done initially on a generic level, e.g. based on the client's self-assessment (e.g. 1-5) and / or regarding specific sustainability concepts / topics (e.g. ESG approaches, Paris agreement, regulation etc.).

However, the client's sustainability and sustainable investment literacy should not be based on this initial assessment alone, but rather supplemented on a regular basis by further assessments. This recommendation is made mainly in view of the fact that the sustainability topic will be subject to strong developments in the next few years, and that clients will also undergo learning processes with regard to sustainability.

The assessment of the client's sustainability and sustainable investment literacy could be made dependent on whether clients show interest in sustainability topics.

It can be considered best practice if ESG approaches are embedded per default into the overall investment strategies and decision processes, e.g. an ESG integration approach, without using this fact as advertisement towards clients.

10 So called "impact investments" as referred to in the AMAS/SSF recommendations of 1 December 2021: How to Avoid the Greenwashing Trap: Recommendations on Transparency and Minimum Requirements for Sustainable Investment Approaches and Product, cipher 4.5, page 16.

3 Ensuring that clients sustainability preferences are matched

Client's sustainability preferences should be matched with respective financial instruments and services, as applicable. The matching process should implement clear and binding client instructions as well as legitimate client expectations[11] raised during the advisory process. From a best practice point of view, it should be analysed whether the matching should occur at financial instrument, on portfolio level or on both levels.

There are various ways of implementing a matching mechanism as it depends on the client's expressed sustainability preferences and any legitimate expectations that have been raised as well as the respective financial services on offer. The applicable key elements of the matching mechanism should be made transparent and communicated to the client. A client should also be informed whether the matching applies on portfolio and / or financial instrument level and whether it applies to all portfolios or only to specific portfolios.

Clients should also be informed on how their sustainability preferences are met based on the discussed investment solutions (e.g. discretionary and advisory mandates).

Depending on the applicable matching mechanism, clients could or, in case of legitimate client expectations, should be informed whether the matching is done:

- based on the client's motivation as defined during the advisory process (financial performance, values alignment, positive change)
- based on product classifications by manufacturers (e.g. exclude financial instruments from the sustainable product universe if they do not qualify as Art. 8 or 9 SFDR products) or based on internal sustainability definitions
- based on sustainability degree or simple client buckets (e.g. high, medium or low) resulting in bandwidths of allocation to sustainable investments
- based on ESG KPIs such as minimum average ESG rating of portfolios
- based on allocation percentage of investments to e.g. SDGs, sustainable investments, thematic financial instruments and impact investments
- based on the temperature alignment of a portfolio (or its decarbonisation pathway)
- based on a minimum percentage of sustainable investment according to SDFR (e.g. for MiFID clients)
- based on the correspondence with defined exclusion criteria

11 See page 7.

4 Regular monitoring of product compliance and performance

Sustainable financial instruments offered to clients should be subject to ongoing monitoring to guarantee that they continue to meet the applicable sustainability criteria. Where investment portfolios are subject to ongoing suitability monitoring obligations, such monitoring should include binding client instructions related to sustainability as well as legitimate client expectations[12] raised during the advisory process. Depending on the concrete circumstances this should include monitoring regarding e.g. the applied elements of matching mechanism explained above and minimal ESG key performance indicators (e.g. minimal rating or carbon footprint on portfolio and / or financial instrument level, exclusions, controversies).

Breaches of binding instructions should be remediated in discretionary mandates. Breaches should be communicated to advisory clients (e.g. via specific alerts or included in transaction reports) and mitigating measures could be defined together with advisory clients.

The monitoring of breaches should also be adequately embedded in the overall internal control framework.

5 Frequency and content of client reporting

Clients who have expressed sustainability preferences should receive regular sustainability related reports on an annual basis or more frequently as agreed with the client. A combination of regular reports, transaction related reports (e.g. as part of the advisory minutes) and alerts in case of material ESG events (e.g. a breach that leads to a mismatch of the portfolio with defined sustainability preferences) could be seen as best practice. The granularity of the reporting should be made dependent on the type of financial instruments and services offered (e.g. standardised reporting vs. more tailored reports).

Client reports should at least contain the alignment of investments with the sustainability preferences. This should include a description of how these preferences have been met by their investments in accordance with applicable matching criteria and could include the same potential elements of matching as listed in section 3.

12 See page 7.

Editorial

Publisher: Swiss Sustainable Finance
The mission of Swiss Sustainable Finance (SSF) is to strengthen Switzerland's position as a leading voice and actor in sustainable finance, thereby contributing to a sustainable and prosperous economy. The association, founded in 2014, has representative offices in Zurich, Geneva and Lugano. Currently, SSF unites over 210 members and network partners from financial service providers, investors, universities and business schools, public-sector entities and other interested organisations. Through research, capacity-building and the development of practical tools and supportive frameworks, SSF fosters the integration of sustainability factors into all financial services. An overview of SSF's current members and partners can be found on its website: www.sustainablefinance.ch

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