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BVI's[1] response to ESMA's call for evidence on the integration of sustainability preferences in the suitability assessment and product governance arrangements

As the representative body of the German fund industry, we see no merit for BVI to respond to the specific questions on the practical implementation of sustainability preferences that primarily affects the market practice at the point of sale.

This being said, we take great interest in how distribution of products with sustainability features evolves and how responsive clients are to the new standards for exploration of their sustainability preferences introduced in August 2022. Based on the experiences of our members and their distribution partners, we must concede that the new standards have not lived up to the regulatory expectations and objectives of facilitating investments in sustainable finance. On the contrary, the most striking market effect has been a decrease of investments in products with sustainability features specifically in the fund market in the recent months. In this regard, we would like to share with ESMA the following observations:

- There are so far no representative figures concerning the percentage of investors that declare to have sustainability preferences as part of the suitability test. However, market soundings and first academic research indicate that in the German market only a small minority of investors confirms such preferences, with figures ranging between 20 and 10 percent.

- Perhaps the most astounding observation is that investors with higher levels of financial literacy tend to say "no" to sustainability preferences more often that average retail investors. The likely reasons for such investment behaviour might be that financially adept investors do not wish to be restrained in their investment choices to products with sustainability features, but prefer to receive recommendation based on the entire investment universe. Limitation of investment choices is generally the most common reason named by investors when asked by their advisers why they opt for "no" with regard to sustainability preferences.

- Out of the investors opting for "yes" in terms of sustainability preferences, between 50 and 80 percent make no further specifications. This means that they neither choose one or several sustainability characteristics they are interested in nor define a focus on either environmental or social matters.

- Another interesting finding emerged from reviewing the outcomes of the suitability test by a robo-adviser: At the first stage, when answering the "Yes/No" question in terms of sustainability preferences, the share of investors interested in sustainability was slightly higher (26 percent) than in traditional advice channels. However, at the second stage, when confronted with the specific

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 116 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 28%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

questions on sustainability preferences, 77 percent of participants have quitted the online suitability test altogether.

- These initial findings indicate that investors are completely overchallenged by the regulatory concept of sustainability preferences. Even investors who take interest in sustainability matters in their daily life are unable to cope with notions of Taxonomy-aligned investments, sustainable investments under SFDR (that remain entirely arbitrary and hence are not even comprehensible to distributors, let alone comparable between products) or consideration of PAIs. Advisers that can anticipate frustrated or discouraged reactions from their clients could be tempted to steer the conversation towards a “no” with regard to sustainability preferences in order to avoid a break-off of the interview that has potentially lasted for hours. This might explain the difference between the share of investors with sustainability preferences in traditional advised and robo-advised sales channels (with the caveat that all findings might not be representative at the current stage).

- These difficulties can be already attributed to market trends: in the first two quarters of 2023, the net sales of open-ended retail funds with sustainability features in the German market were rather at a low level with overall EUR 2 bn, while retail funds without sustainability features made up for EUR 9 bn. This is a significant shift in investment behaviour compared especially to the situation in 2021 after the entry into force of SFDR when funds with sustainability features collected net EUR 48 bn of fresh money compared to EUR 42 bn that flew into other investment funds. While the figures must be interpreted with all necessary caution and in light of a changed macroeconomic environment, it is still quite obvious that the regulatory expectations for a greater shift towards sustainability-related investments have failed so far.

We are aware that ESMA has only limited means to remedy the current deficiencies since they are the outcome of the wider regulatory framework that has been insufficiently coordinated and tested in practice. Nonetheless, we would like to encourage ESMA to explore ways for overcoming the most blatant flaws of the current regime, in particular:

- **Waiving the requirement to ask clients about their preferences for product features that are not available in the market:** This pertains in particular to preferences for high shares of Taxonomy-aligned or sustainable investments. Investors with such pronounced sustainability preferences are currently being frustrated and discouraged by the lack of investable products. From distributors’ feedback, we understand that in such situations, investors are more inclined to break off the suitability assessment altogether.

- **Allowing exploration of the clients’ sustainability preferences in more general terms without the necessity to determine preferences for minimum proportions of Taxonomy-aligned or sustainable investments:** Proportions of sustainable investments reported under SFDR currently lack any kind of comparability, meaning that products with comparable investment strategies and portfolio composition might display very different levels of sustainable investments. The Morningstar manager research for Q4 2022 has looked into minimum proportion of sustainable investments disclosed by 11 funds tracking large cap Paris-aligned benchmarks and thus having broadly similar portfolio holdings. The range of minimum sustainable investment allocation in these funds was between 80 percent and one percent as of September 2022 and between 50 and 10 percent as of December 2022. It is quite likely that the reported minimum proportions have been again adapted in the meantime as a consequence of the Commission’s Q&As on SFDR from April 2023 that indicate that all constituents of Paris-Aligned Benchmarks or even Climate Transition Benchmarks may be deemed sustainable investments. In the end, asking clients about their specific preferences for minimum proportions is quite pointless in this market environment.

The heart of the current problems, however, is the lack of universally applicable standards for sustainable products that could be associated with broader concepts like achieving sustainability outcomes, supporting transitioning companies or limiting sustainability risks that could be easily understood by retail investors. The upcoming SFDR review will hopefully provide an opportunity to explore the merits of introducing such standards and adapting the regulatory concept for sustainability preferences. ESMA’s active contribution to the regulatory review based the outcome of this call for evidence would certainly be beneficial for ensuring that any new EU initiatives are better aligned with the market reality and the needs of retail investors.