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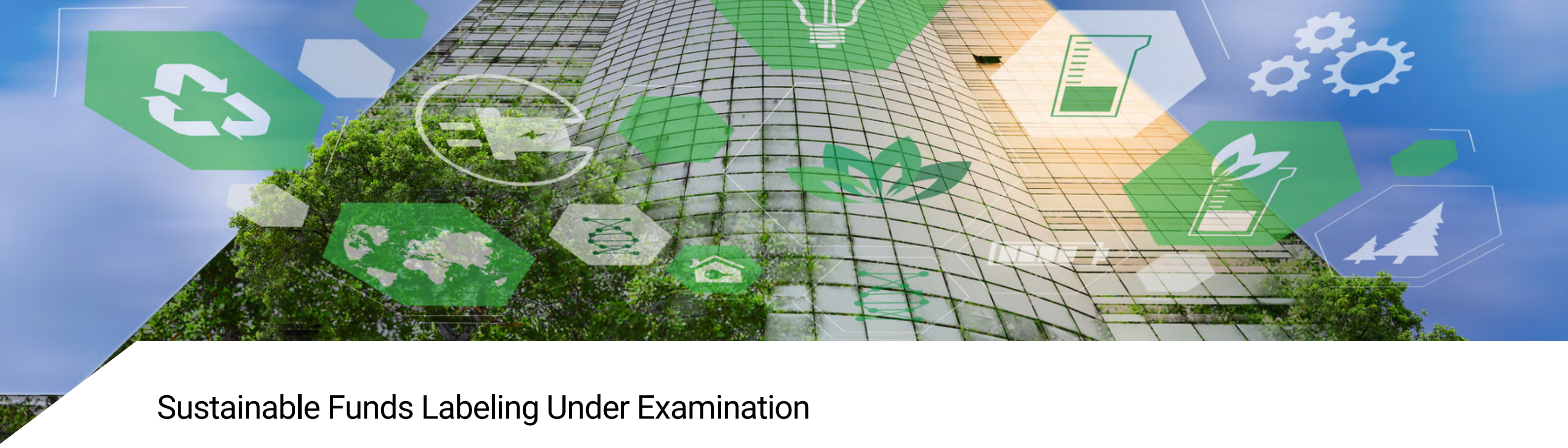
In this issue:



Sustainable Funds Labeling Under Examination

The public appetite for sustainable investment is by now well understood and something that is uppermost in the minds of those responsible for the marketing of investment fund products. But the ability of concerned investors looking to target funds that adhere to environmental, social, and corporate governance (ESG) standards is compromised by confusion over terminology related to investment practices.

The claims and credentials of “sustainable” funds are under increasing scrutiny. Recent evidence of this was the reported decision of Morningstar to remove more than 1,200 funds with a combined $1.4trn in assets from its European sustainable investment list following a review of investor disclosures in prospectuses and annual reports.

How to define ‘ESG’

Confusion over the terminology applicable to investment products with a sustainable brief begins at the definitional level. Terms such as sustainable investing, impact investing, responsible investing, and ESG investing are habitually used interchangeably with little regard for the nuanced differences between them.

The reality is that what is typically called “sustainable investing” as an umbrella term covers a spectrum of investment approaches rather than a single, unified methodology. These range (at the lower end) from the avoidance of negative outcomes in an investment or real-world context – which is, technically speaking, responsible investing – to (at a more demanding level) actively advancing positive outcomes – which is known as impact investing.

From portfolio exclusions to active ownership

So, at the lower end of the ESG spectrum, investors can apply exclusions to their portfolio, rejecting issuers involved in providing certain products or services or involved in a particular industry such as tobacco or armaments. Moving up the ladder they may seek to limit ESG risk: here they rely on ESG information that usually takes the form of ESG company ratings supplied by various providers. This same information can also help to identify and prompt investment in companies that are sustainability leaders. Ultimately investors with the highest level of ESG commitment may look to influence positive ESG outcomes by practicing active ownership through engaging directly with companies on ESG issues.

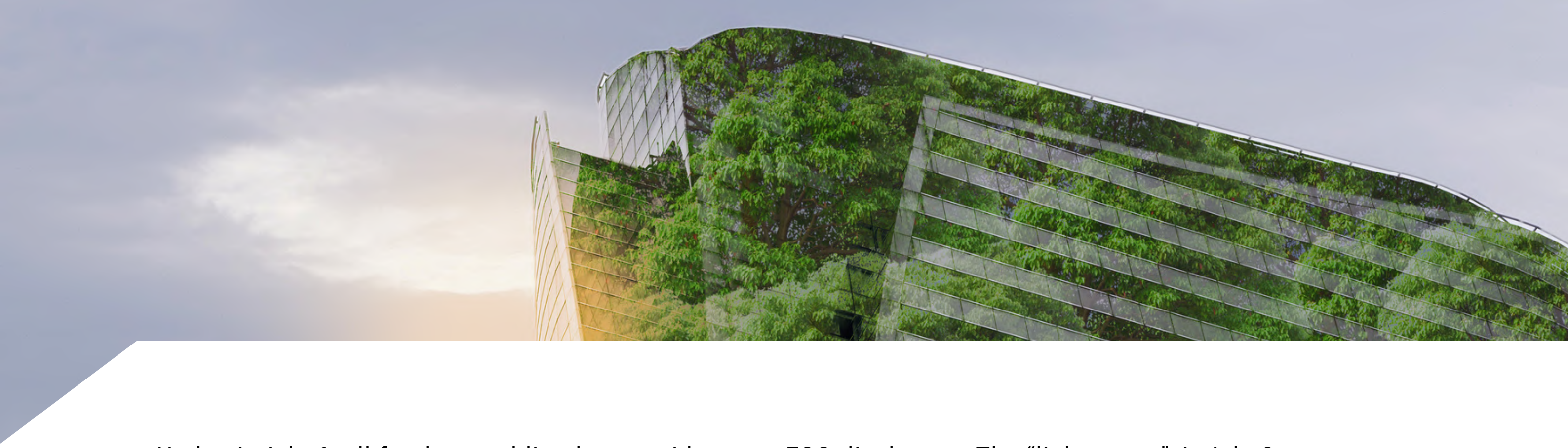
What is clear is that without reliable ESG information effective sustainable investing is an impossible task. At the level of investment funds, Europe leads the way. The labeling of investment funds in a sustainability context is enjoying a new degree of clarity since the European Union introduced its Sustainable Finance Disclosure Regulation (SFDR) just over one year ago. This landmark regulation obliges asset management companies to provide certain information on their products' ESG risks. The objective is to promote responsible and sustainable investing while preventing greenwashing.

Classifying funds under SFDR

Under the SFDR, investment funds for sale in the EU must be classified by their managers as Article 6, 8, or 9, depending on their sustainability objectives.

Exhibit 1 SFDR Classification

Source: Morningstar Research.

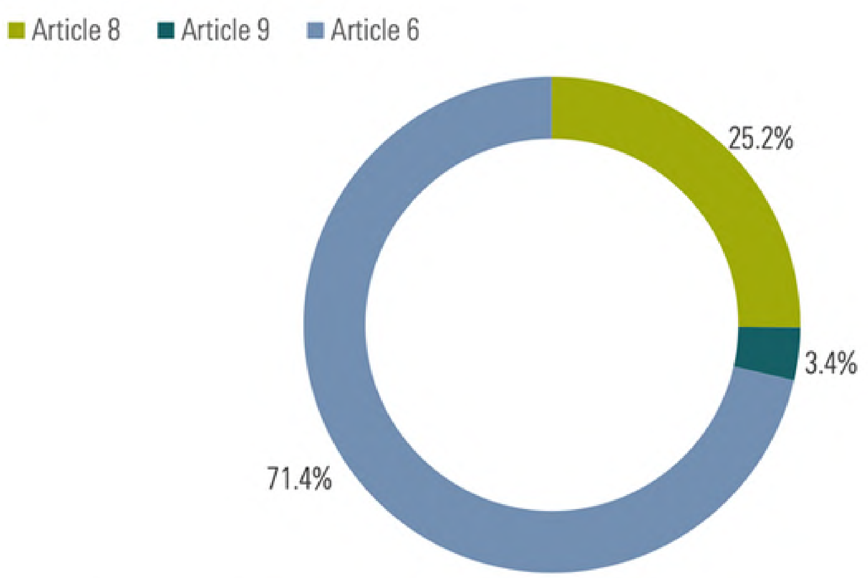


Under Article 6, all funds are obliged to provide some ESG disclosure. The “light green” Article 8 category includes financial products that promote environmental and/or social characteristics where the underlying companies follow good governance practices. Article 9 (dark green) investment vehicles have more demanding ESG disclosure requirements; they must have an explicit sustainable investment objective.

Clearly the new labeling regime has had an impact on investor behavior. Assets in Article 8 and Article 9 funds reached EUR 4.05 trillion at the end of December 2021. This sum represented 42.4% of all funds sold in the EU. Indeed, in the fourth quarter of last year, Article 8 and Article 9 funds captured 64% of EU fund inflows, at EUR 81.4 billion.

The impact of the SFDR was also felt in terms of product development with just under 200 new Article 8 and Article 9 funds, or 54% of new fund launches, coming on stream in the EU in Q4 2021.

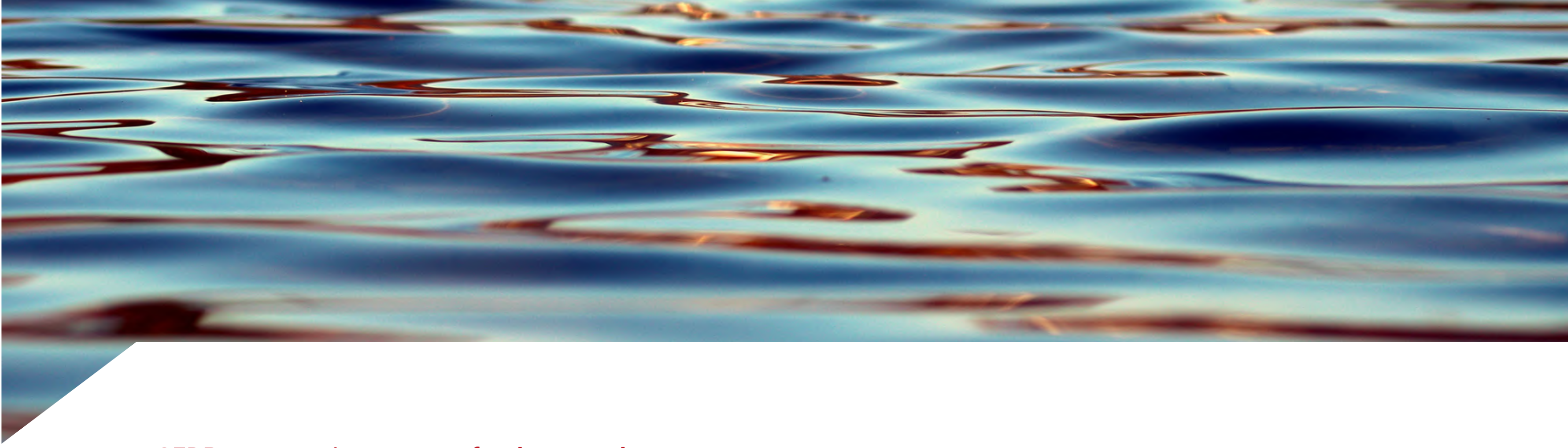
Exhibit 2 SFDR Fund Type Breakdown (by Number of Funds)



Source: Morningstar Direct. Data as of 31 Dec 2021. Based on SFDR data collected from prospectuses on 91% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

Source: Morningstar

Morningstar also noted that asset managers continued to reclassify strategies from Article 6 into Article 8 or Article 9 “by enhancing ESG integration processes, adding ESG exclusions, or switching to brand-new strategies.” But, ominously, “changes to justify a reclassification vary in depth and breadth.”



SFDR prompts investment funds upgrades

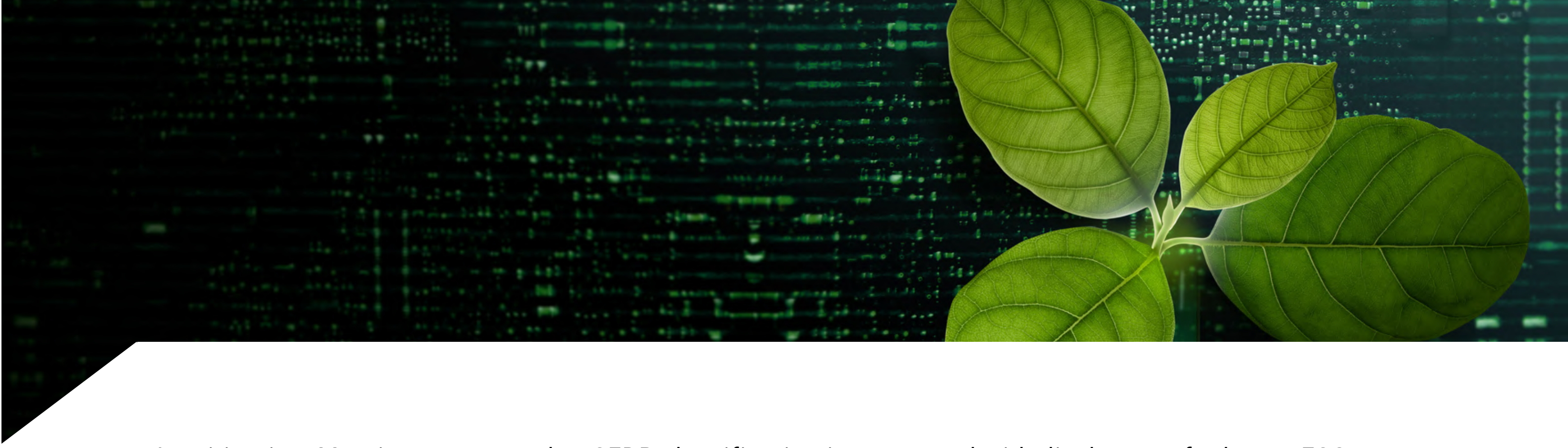
According to Morningstar, asset managers have “retooled” Article 6 funds by enhancing their ESG integration processes and/or adding binding ESG criteria to their investment objectives and/or investment policies. “The changes applied to these funds vary greatly, ranging from adding exclusionary screens to a complete overhaul of the investment objective, investment policy, and holdings.”

Additionally, since the introduction of SFDR on March 10, 2021, around 1,800 funds were upgraded either from Article 6 to Article 8 or Article 9, or from Article 8 to Article 9. A minority of these upgraded products changed their name.

Yet Morningstar identified numerous examples where ESG disclosure practices leave something to be desired and this would seem to be behind the company’s decision to remove funds from its sustainable investing list.

Such light-touch and business-as-usual approaches have legitimately raised concerns that asset managers are greenwashing their product ranges, and that investors could be misled in thinking that funds marketed as promoting ESG characteristics or pursuing sustainable goals are noticeably different from what they were prior to SFDR or different from similar offerings that haven't been classified as Article 8 or Article 9.

Source: Morningstar, SFDR Article 8 and Article 9 Funds: 2021 in Review



In mitigation, Morningstar notes that SFDR classification is concerned with disclosure of relevant ESG information and does not constitute an ESG label. To assess funds' ESG credentials, additional analysis and metrics are required. Guidelines around ESG metrics under SFDR are being formalized by the EU's Taxonomy Regulation, which is a classification system for environmentally sustainable economic activities – something that will greatly increase transparency and equip investors with the information they need to align their investment practices with their ESG principles.

Intuition has a number of tutorials relevant to the content of this article:

- ESG – Primer
- ESG – An Introduction
- ESG Factors
- Sustainable & Responsible Investing – An Introduction
- Sustainable & Responsible Investing – Strategies
- Impact Investing
- ESG Reporting
- Sustainable Finance Disclosure Regulation (SFDR)
- Taxonomy Regulation (Europe) (*Coming Soon*)

New Sanctions Regime Expands Frontiers of Financial Crime

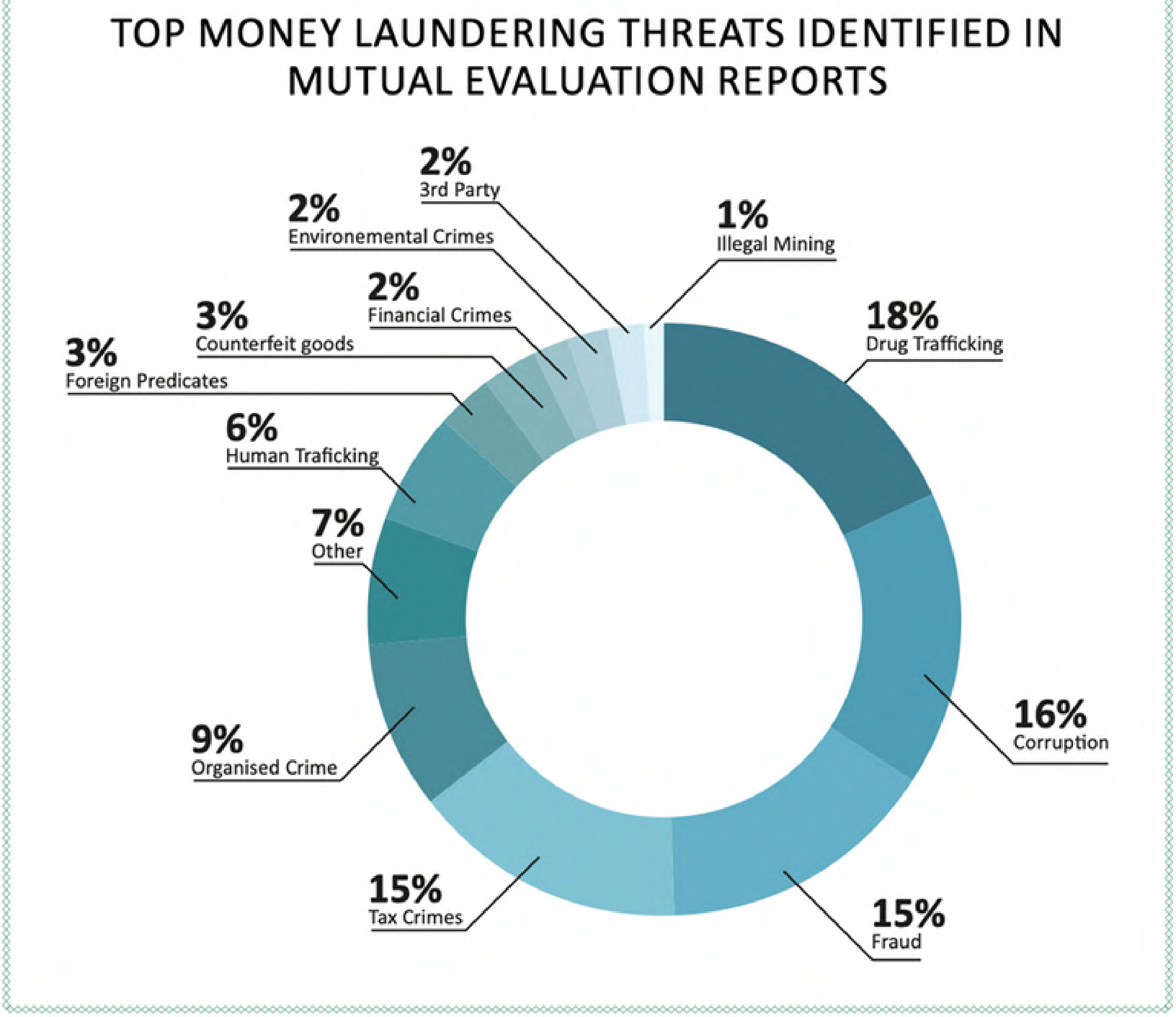
The wave of sanctions following the Russian invasion of Ukraine is a punctuation point in the fight against financial crime. Meanwhile, the massive expansion in sanctions has coincided with a burst of activity on the part of the Financial Action Task Force (FATF), the global money laundering and terrorist financing watchdog.

Since the Russian invasion of Ukraine on February 24 well over 1,000 individuals have been hit with financial sanctions that had the effect of freezing or confiscating assets held in various jurisdictions around the world. This has resulted in a greatly increased scope of activities for anti-financial crime compliance professionals – but at the same time it has, for many of those individuals, introduced a welcome element of clarity into everyday operations.

Money laundering – a subset of financial crime

It is often mistakenly believed that the overwhelming preoccupation of bank financial crime compliance staff is with anti-money laundering (AML). In fact, AML is just a subset of the far wider realm of financial crime – the latter encompassing not just money laundering but sanctions evasion, bribery and corruption, drugs trafficking, human trafficking, counterfeiting, tax evasion, and modern slavery.

Figure 1.1.



Source: In-text review of 59 country mutual evaluation reports, consisting of 29 FATF and 30 FSRB Members. Financial crimes in chart refers to securities fraud, market abuse, and insider trading.

In the case of the recent expansion of the sanctions regime, money laundering has again moved center stage. Money laundering is the process of disguising the proceeds of a criminal act. But while money laundering volume has increased dramatically, this needs to be viewed in the context (and as a function of) the original crime, which is sanctions evasion. In short, it is necessary to decouple money laundering from financial crime, specifically sanctions evasion.

Sanctions expansion and 'designated funds'

The circumstances that led to the expanded sanctions regime has prompted a large degree of soul-searching in Western jurisdictions that have for years effectively provided sanctuary for assets that heretofore were considered legitimate but, since the expansion of the sanctions regime, are 'designated funds' and must first be identified and reported to the relevant sanctions authority, and cannot be processed without explicit approval from that authority.

And this expanded sanctions regime has coincided with an active period for the FATF. The FATF is an inter-governmental body that sets international standards in these areas with a brief "to generate the necessary political will to bring about national legislative and regulatory reforms." Central to this are the FATF's 40 Recommendations issued in 2012.

FATF cites "substantial challenges"

April saw the FATF publish a 'landmark' report on the state of effectiveness and compliance with FATF standards as part of a three-year strategic review of its operations. FATF reports that 76% of countries have now satisfactorily implemented its 40 Recommendations in their laws and regulations – a "significant improvement in technical compliance, which stood at just 36% in 2012."

Yet many jurisdictions, according to FATF, still face substantial challenges in taking effective action commensurate to the risks they face. "This includes difficulties in investigating and prosecuting high-profile cross-border cases and preventing anonymous shell companies and trusts being used for illicit purposes."

It is this issue of beneficial ownership that has risen to the top of the agenda in the fight against financial crime. By coincidence, the FATF in early-March adopted amendments to Recommendation 24 and its Interpretive Note, which "require countries to prevent the misuse of legal persons for money laundering or terrorist financing and to ensure that there is adequate, accurate, and up-to-date information on the beneficial ownership and control of legal persons."

For Lee Byrne of the Great Chatwell Academy of Learning, a global financial crime specialist who advises and trains a range of international financial and non-financial institutions, including AML supervisors, the expanded sanctions regime has brought increased work but has in many respects made the job of financial crime compliance professionals somewhat easier.

Financial crime compliance and commercial tension

"We now have a definitive statement of who the bad guys are," says Byrne. "Until now people had a personal view of these people of who maybe they didn't approve of but they weren't definitively labeled as criminals. Now that they've been sanctioned and their assets designated and are subject to licensing constraints, some people are welcoming that."

According to Byrne there will always be a tension between financial crime compliance professionals and the commercial side of the business. For the latter, it is understandable that clients and prospects are considered innocent until proven guilty, because the vast amount of customers are honest people. The new sanctions regime now makes it easier to delineate between those two groups.

"The commercial team are important to support the growth of businesses and can be as much as 60-80% of the business resource and then there's a smaller team of financial crime professionals. Until the last few years, some businesses were more supportive on the compliance side than others, others operated on a 'just in time' basis, and others considered failure as not material reputationally and a cost of doing business. We are now seeing more support for financial crime compliance, and thankfully, the attitude that 'compliance is a business blocker' is changing because of the hard work and dedication of compliance professionals in improving the effectiveness of training and communication, and explaining why compliance is important to stop crimes and terrorism, and not just to meet regulatory requirements."

That doesn't mean the job of compliance is anything other than a difficult one. The reality is that the assets of those newly fallen into the sanctions net left their home country long ago and are now spread and secreted across the OECD countries, invariably using proxies to make tracing of beneficial ownership so much harder. In that respect, any moves by the FATF improve the transparency of beneficial ownership of companies, and therefore assets, is to be welcomed.

Financial crime compliance requires change of mindset

But criminals will always be one step ahead unless there is a change of mindset on the part of financial crime compliance professionals.

The reality is we publish outline principles of regulation three to four years ahead of actual implementation," says Byrne, citing the historical FATF pronouncements in 2012 and the EU 4th Anti-Money Laundering Directive, published in 2015. This effectively gives criminals a roadmap and a head start to plan new and ever more sophisticated ways to avoid detection.

The answer, according to Byrne, is that compliance staff need to rely less on regulatory guidance and to take the initiative and encourage staff to develop a mindset that is "think like a criminal, otherwise you won't make a meaningful impact."

Intuition Know-How has a number of tutorials relevant to the content of this article:

- Sanctions
- Global Anti-Money Laundering (AML)
- UK Anti-Money Laundering (AML)
- US Anti-Money Laundering (AML)
- Singapore Anti-Money Laundering (AML)
- Hong Kong Anti-Money Laundering (AML)
- Japan Anti-Money Laundering (AML)
- UAE Anti-Money Laundering (AML)
- Ireland Anti-Money Laundering (AML)
- Kingdom of Bahrain Anti-Money Laundering (AML)
- Ghana Anti-Money Laundering (AML)
- UK Anti-Bribery & Corruption (ABC)
- Foreign Corrupt Practices Act (FCPA)
- Ireland Anti-Bribery & Corruption (ABC)
- Anti-Bribery & Corruption (ABC) in Asia