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MiFID II: A threat to European sustainability?

BY NEIL SCARTH MARCH 2022 (MAGAZINE)

MiFID II is unintentionally jeopardising the long-term objectives of ESG investors

Key points

- Fundamental research budgets are under pressure while ESG costs are rising
- There is greater regulatory and client pressure for fund-level ESG integration
- How can managers independently measure ESG inputs?
- How can they fairly and transparently allocate ESG costs to funds/clients?
- How can they demonstrate ESG integration at the fund level?

Global regulatory initiatives designed to prevent greenwashing in ESG funds are raising fundamental questions of fiduciary responsibility for European asset owners.

If regulators are sufficiently concerned to investigate the potential overstatement of ESG integration by certain asset managers in order to protect investors, what responsibility do pension trustees have to ensure that their external ESG mandates are operated on a sustainable basis on behalf of their pension beneficiaries?

Has the bull market of recent years combined with seemingly universal enthusiasm for ESG objectives obscured risks for pension beneficiaries?

Pension funds should be able to answer the following questions:

- Are external ESG mandates (and agreed strategies) sustainable over the timeframes required to achieve our ESG objectives?
- Are there market risks related to external ESG mandates?
- Are there regulatory risks related to external ESG mandates?
- Are there investment team turnover risks in external ESG mandates?
- What responsibility, if any, do pension fund manager selection teams have to ask these questions?

ESG regulation is only one side of the equation. The authors of MiFID II could not have anticipated the complex interaction between MiFID II research provisions and a rapidly evolving ESG regulatory framework which was, at the time, not even on the distant horizon. Yet this is where asset managers, asset owners, governments and regulators find themselves today.

This interplay will create greater complexity for asset owners as the sustainability of seemingly discreet ESG strategies can be heavily influenced by MiFID II considerations that weren't designed with ESG in mind.

In Europe, because both fundamental research and ESG budgets are primarily funded by the manager's profit and loss account (P&L) post MiFID II, (unlike in the US), ESG and fundamental research budgets should rapidly merge, as they are both funded from the same source.

This should also be driven by the fact that almost all funds need both types of inputs.

Fundamental: even the greenest funds need fundamental inputs to assist with security selection. It is not possible to run a portfolio based on carbon data alone.

Regulatory: both regulators and clients are increasing their focus on actual ESG integration at fund level. Managers who cannot clearly articulate how both fundamental and ESG inputs are used in specific funds run the risk of potentially overstating the level of ESG integration – reportedly the substance of the Securities and Exchange Commission's complaint against DWS in the US.

Research silos

Successfully combining ESG and fundamental research processes will require a unified methodology for valuing all inputs; ESG inputs are, after all, still essentially research.

ESG regulatory backdrop

- EU – SFDR requires ESG risks to be considered in all funds and specific fund-level reporting requirements ESG specialist funds.
- UK – Requires that all ESG funds be ‘adequately resourced’ – on an ongoing basis.
- US – SEC has served notice that ESG funds are expected to operate as per product descriptions.

Enforcement actions

SEC and BaFIN are investigating the alleged overstatement of ESG integration at the fund level at DWS. Relevant statutes include securities fraud in the US, and mis-selling in the UK.

Yet, for the vast majority of managers, ESG and fundamental research valuation processes exist in completely separate silos. The longer managers allow this to persist, the greater the likelihood that they can be accused of overstating ESG integration – because the processes are essentially separate.

There are several causes for this, including a lack of integration between ESG and fundamental investment teams and the fact that the inputs are heterogeneous – documents and interactions for fundamental teams; data/databases and stewardship (proxy advisers) for the ESG teams.

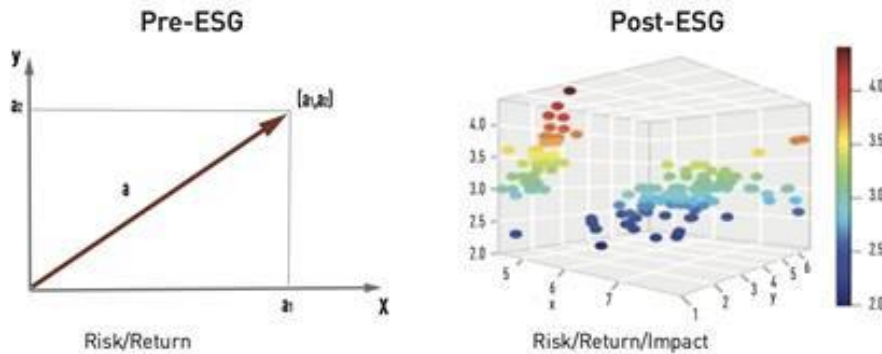
This divide is completely understandable. Despite the fact that many managers claim to have been practising sustainability for a long time, ESG has had the most transformative impact on the investment process since the development of modern portfolio theory and securities analysis – because it adds a third variable (impact) that the conventional two-dimensional, risk-return investment framework has no way to accommodate.

Not only does ESG require inputs, like databases and proxy advisors, which cannot be valued by MiFID II research valuation approaches, this new mix of inputs must be applied to a wide variety of ESG specialist funds and generalist products, all of which will use them in different proportions, reflecting the varying investment objectives.

Until recently there was a lack of tools to solve this paradox.

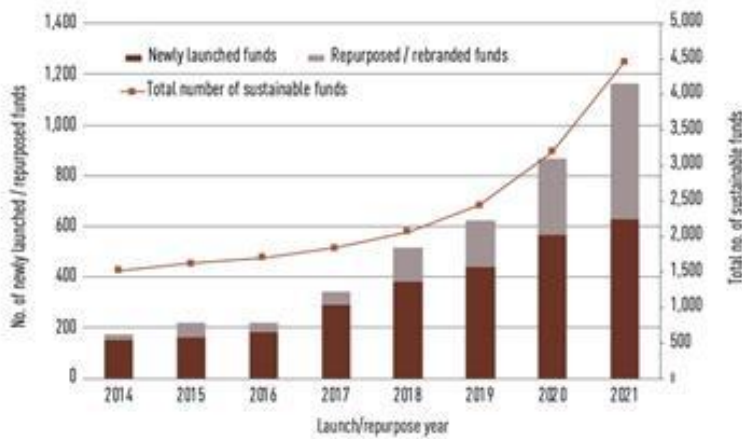
1. ESG has changed the investment world

Research valuation solutions designed for a 2-dimensional world do not work in a 3-dimensional world



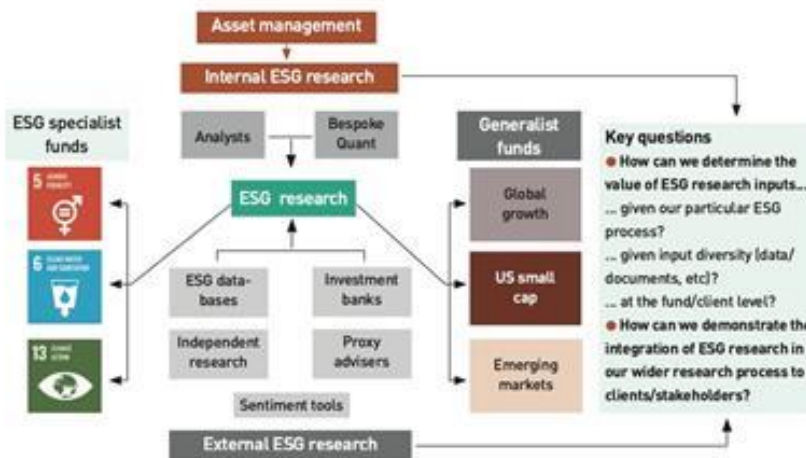
Source: Frost Consulting

2. Explosive growth of ESG funds



Source: Morningstar

3. ESG integrational challenges – critical questions



Source: Frost Consulting

Given the magnitude of this transition, it is not surprising that research valuation tools designed for the two-dimensional MiFID II environment are of little use in such a three-dimensional context (figure 1).

In the MiFID II world, the primary means to value research is to count the consumption of documents and interactions from investment banks at the asset manager level.

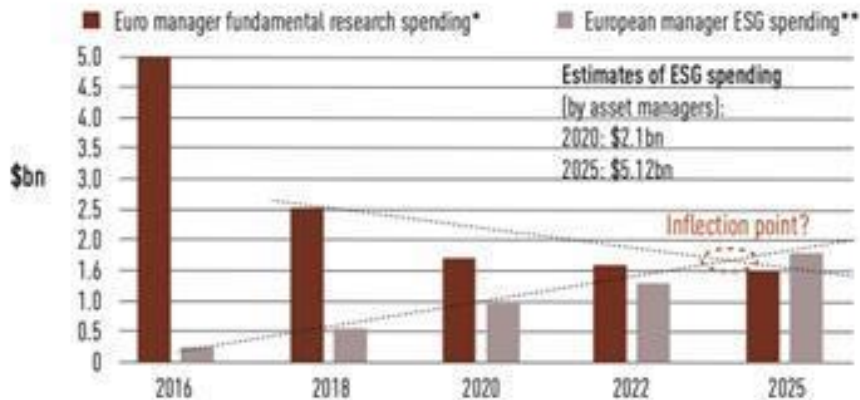
This process does not remotely address ESG integration. A tally of documents cannot possibly determine the value of a climate database to an impact fund, for instance.

Research valuation processes must evolve to encompass the third dimension. In the integrated world, inputs must be valued at the fund level, given the enormous range of fund-targeted outcomes (including ESG or impact) and the variety of inputs required to achieve them.

Widespread relabelling

Another reason for the lack of integration between fundamental and ESG research has been the rapidity of the growth of the ESG segment. This has been the fastest-growing active product within recent memory, and in many cases the blizzard of fund launches have run ahead of managers' ability to integrate these process.

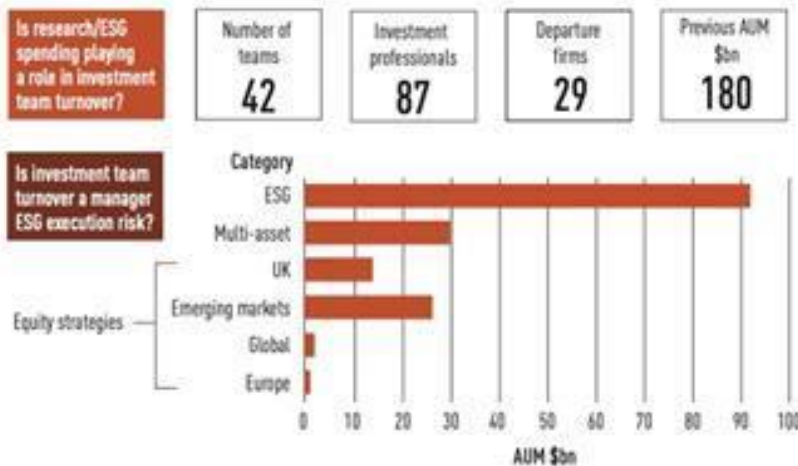
4. Research versus ESG spending



* Source: Estimate Frost Consulting

** Source: UBS/Frost Estimates

5. Migration of investment teams from P&L managers post MiFID II*



* Source: Frost Consulting, Media reports

Figure 2 illustrates the rapid growth of ESG funds.

Most notably, the vast majority of these 'ESG' funds are not new. Roughly 80% of them were some other type of product as recently as last year. Morningstar, upon further analysis, determined that 1,600 funds self-labelled as 'ESG' by managers, no longer met Morningstar's ESG criterion.

Given the recent transition of these funds, they may have the greatest burden of proof relating to greenwashing. They need to prove that their investment processes have really changed.

However, it seems unlikely that a series of research budgeting techniques designed for traditional funds will be equally effective in an ESG context.

Furthermore, ESG has created a far greater range of fund objectives.

From both a client and regulatory perspective, fund-level attribution will be critical, given the wide range of desired fund outcomes.

For many managers, the rapid pace of ESG fund launches combined with the continued siloing of ESG and fundamental research valuation processes, means they struggle with questions about fund-level attribution. This critical last mile of ESG integration has essentially been ignored.

At firm level, managers obviously know which ESG databases and proxy advisers they use, and how they customise those inputs to reflect their own ESG priorities. At security level, most will have industry-sector materiality maps, proprietary internal company ESG scores and a record of engagement with specific companies.

But in most cases, even the most sophisticated ESG managers have not translated this at fund level, which represents a serious risk from both a client and regulatory perspective.

It seems ironic that in the midst of huge investments by managers in ESG franchises, managers have ignored this critical gap, potentially exposing themselves to significant commercial and regulatory risk. The mere suggestion of greenwashing can be fatal, even before considering the increasingly multi-asset nature of ESG products and the fact that they now straddle public and private markets.

Consequently, it is not surprising that global regulators are now focusing on fund-level outcomes, once again partly as a function of the wide variety of fund objectives.

Cost allocation is crucial

This raises the related notion of how central firm-wide ESG costs are fairly allocated to strategies, not only to ensure that ESG strategies are appropriately resourced, but also to address cross-subsidy issues for those asset owners funding manager research and ESG budgets. In the US, the vast majority of ESG inputs will continue to be funded by US asset owners under 28 (e) of the Securities Exchange Act of 1934.

This comes against the backdrop of rapid consolidation among ESG data vendors and constantly rising prices. Furthermore, the pricing of these databases is frequently opaque – so much so, that regulators in France, the UK and Holland are threatening to intervene.

At present very few managers have a coherent methodology for transparently and fairly allocating central ESG inputs and costs to the funds that use them. These inputs can be used in widely varying proportions between funds, but from a MiFID II perspective all funds that consume research should pay for it (if not necessarily the same amount).

Benchmarking can also play a helpful role in this process. Given that asset owners are invested in specific funds, they should seek the answers to these questions from their underlying ESG mandate managers at the fund level.

Rapidly rising ESG input costs are one of the factors in the complex interaction with the MiFID II research regime in Europe. As noted earlier, many managers in Europe that chose to fund research via their P&L have cut research spending heavily in an attempt to enhance profitability. While research costs for asset owners are very small 3-4 basis points versus long-term returns of around 700bps, when this cost is transferred to the P&L of the asset manager it frequently becomes their second-largest cost – behind staff compensation.

And, as previously mentioned, decisions to fund research via P&L were taken well before ESG at this scale and cost level became evident. Figure 4 shows the interplay of these (suddenly related) spending categories.

One risk that asset owners seem unaware of is the possibility that these budgets may start to cannibalise one another, which is not likely to be in the asset owner's best interests, further underscoring the importance of asset owners asking the right questions of their managers.

A further consideration is that these cuts in research spending by P&L managers in Europe (averaging around 75% since pre-MiFID II levels), have taken place over a period in which the broad equity indices have appreciated by about 60%, substantially buoying manager revenue and profitability.

Now, in light of the unexpected, increasing and significant cost of ESG, asset-owner risk managers should be considering the impact on the sustainability of these strategies if there is a bear market. As both

fundamental research and ESG budgets come from the manager's P&L, they can rapidly contract when markets go down.

We got a sneak preview of this during the first quarter of 2020 during the COVID market meltdown when US equity trading volumes, the key leverage factor for research budgets, increased by 40%. In Europe, by contrast, where the leverage factor for research budget is pre-tax profits, AUM fell by 24% and pre-tax profits by a likely 50%, with a commensurate hit on research budgets.

If the markets had not rallied very sharply after the March 2020 lows, European managers would have had to cut fundamental research and ESG budgets sharply – unless they were to become non-profit social enterprises.

Ironically, European asset managers are far less sustainable and resilient than they were on the eve of the great financial crisis, when research costs were still paid by asset owners, and today's significant ESG costs for the most part didn't exist.

Regulatory scrutiny on research costs

In 1Q 2020, European regulators suddenly foresaw one of the unexpected outcomes of the MiFID II research regulations. It was the realisation that the lower markets went, the less and less research would be available to P&L managers as its availability was a function of the manager's profitability.

Sudden awareness by regulators of this unexpected outcome probably contributed to the UK's Financial Conduct Authority (FCA) and the European Securities and Markets Authority (ESMA) unwinding some of the MiFID II research rules.

Furthermore, long-term European ESG objectives are now being funded almost solely by asset managers whose very volatile profitability is primarily a function of financial-market direction. Hence, probably unintentionally, European ESG objectives are now held hostage to market risk.

European asset managers have analysed the sustainability risks of every industry on the planet, except their own.

In light of this, it is surprising that more asset owners and consultants haven't asked the following key question of their ESG managers: why are

US asset owners happy to fund manager research and ESG budgets while their European counterparts are not?

With the benefit of post-MiFID II hindsight, another long-term impact of European research and ESG underspend is becoming apparent. Investment teams, starved of the information they need to maximise investment performance, tend to move to more generously funded managers.

In research by Frost Consulting, we tracked 42 departing investment teams and 87 investment professionals, managing \$180bn since the introduction of MiFID II and found that ESG teams were disproportionately likely to leave (figure 5). We also contrast the actual cost to asset owners when investment teams leave with the low basis points of research cost that might have prevented a teams departure in many cases.

To summarise, we believe that:

- European ESG strategies are unsustainable from a business perspective, given the current funding mechanisms – unless markets rise continuously until 2050, governments fund ESG objectives directly, or asset managers become non-profit enterprises.
- As they stand currently, European ESG objectives are subject to huge implicit public market risks.
- European external ESG mandates are subject to significant regulatory risk unless managers do a better job of proving ESG integration at the fund level.
- The current funding structure introduces substantial investment-team turnover risk.

There is one simple, sustainable solution, however. This would be to adopt the US model where asset managers and asset owners share the cost of ESG implementation. If managers provide transparent, mutually agreed research and ESG budgets, asset owners should be willing to take advantage of their low research costs and long duration to fund them.

The time for Europe to address this vast funding duration mismatch is immediately – not during the middle of a bear market. Common ground on ESG notwithstanding, the adversarial positioning of asset managers and asset owners stemming from the counter-productive MiFID II

research debate, may require government or regulatory intervention if European ESG objectives are going to stand more than a snowball's chance in hell of being realised.

European asset owners should be incentivised to underwrite long-term ESG risks. The futures of their beneficiaries depend on it.

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