Integrating sustainability into MiFID II/IDD: not as straightforward as it seems

The ESG regulatory roadmap for private banking is driving actors to channel their efforts into implementing the Delegated Regulations*, which amend the second Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD). They will apply from 2 August 2022.

Seemingly a typical regulatory update for investment firms at first glance, the Delegated Regulations' repercussions have shaken the core business and operations of organizations providing investment advice and portfolio management services. The Delegated Regulations were adopted on 21 April 2021. One year on, we've identified the top three challenges that financial players are encountering, based on our experience and interactions with the financial community.

1. Upgrading existing systems

Integrating sustainability into financial players' existing MiFID II/IDD processes and tools goes beyond inserting just a few fields. In particular, investment firms' systems will need additional functionality to perform a range of tasks, including but not limited to:
- collecting and storing customers' sustainability preferences in addition to investor profile information, such as customers' risk tolerance, financial situation, knowledge and experience, and investment objectives
- collecting and storing ESG data on products and services to indicate which

are considered "sustainable"
- updating the ruleset to perform suitability tests on sustainability preferences
- updating client reports to provide information on the sustainability characteristics of their investments/portfolios.

A stringent IT implementation plan is essential to cope with these changes and maintain the quality and efficiency of operational activities, e.g. automating sustainability checks and reports as much and as widely as possible.

2. Lacking ESG data to qualify financial instruments as "sustainable"

The Delegated Regulations have strengthened the rules for qualifying financial instruments as "sustainable". To comply with these rules and meet customers' sustainability preferences, investment firms will need to collect ESG data on their products to show how they qualify them as sustainable. This has proved extremely challenging, especially when ESG data is incomplete or insufficiently structured to define and classify a product under ESG rules.

ESG data providers' labels and ratings will no longer suffice; instead, investment firms will need to apply one of three criteria to qualify their financial instruments as "sustainable":
1. A minimum proportion invested in environmentally sustainable investments as defined by the EU Taxonomy — Article 2, point (1) of Regulation (EU) 2020/852.
2. A minimum proportion invested in sustainable investments as defined by the Sustainable Finance Disclosure Regulation (SFDR) — Article 2, point (17) of Regulation (EU) 2019/2088.
3. The Principal Adverse Impacts (PAI) on sustainability factors are considered.

As of today, the market offers limited information for organizations to apply these criteria. Instead, ESG data will be progressively made available to market players along the following timeline:
- **From June 2022**: Application of the European ESG Template (EET), a document to be completed by product manufacturers. The EET, developed by the Financial Data Exchange (FinDatEx), lists ESG data fields defined in the SFDR, EU Taxonomy, MiFID II and IDD. It will provide some (but not all) of the data that distributors and insurance companies require under MiFID II and IDD by 2 August 2022.
- **From January 2023:**
o Application of the SFDR Regulatory Technical Standards (RTS). These apply to the disclosure of pre-contractual information that shows how a product is aligned with its sustainable investment objectives, i.e. through a designated index as a reference benchmark or explaining how these objectives will be attained.
o Reporting on how an organization's activities align with the EU Taxonomy's first two objectives, climate change action and climate change mitigation.
- **From June 2023**: Publication of entity-level PAI information disclosed under the RTS for the 2022 calendar year.

3. Upgrading commercial offers

The Delegated Regulations have driven financial market players to ask some fundamental questions, including:
- Which of our existing commercial offers can be flagged as "sustainable"?
- How should we upgrade our products and services to grow our offering and meet customers' sustainability preferences?
- What are the implications around costs, required resources, risks, change management and integration into our day-to-day activities?
- Which decisions should we take today, considering the market will significantly evolve in the coming months?

At the moment, there are no straightforward answers to these questions. With much broader implications than a usual regulatory update, implementing these new MiFID II and IDD sustainability requirements begs deep analysis and thoughtful decision-making around investment firms' strategy and core functioning. Additional challenges inherently follow, from adapting change management processes and providing training to employees carrying out these changes, to implementing thorough communication plans to keep stakeholders aware and engaged.

Where does your organization stand in implementing these new requirements and its overall journey towards sustainability?

Whatever the challenges your organization has come up against, KPMG Luxembourg's dedicated sustainable finance team can help you successfully implement sustainability into your strategy, systems and processes. If you have any questions or would like customized advice, please contact Julie Castiaux** to get started.

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**Delegated Regulations refer to:*
1. The Delegated Regulation (EU) 2021/1253 amending the Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms.
2. The Delegated Regulation (EU) 2021/1269 amending the Delegated Regulation (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations.
3. The Delegated Regulation (EU) 2021/1253 amending the Delegated Regulation (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.
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How to properly and sustainably invest in Gold?

By Ivaylo MARKOV, Managing Partner of Thales Solutions

Investing an important part of their savings in physical gold can be challenging for investors more habitual to trading stocks and bonds online through brokers or banks. When it comes to physical gold, people are generally interacting with dealers outside of traditional brokerages, and they often need to pay for storage and obtain insurance for the processed investment. If we determine the three main possibilities offered to invest in physical gold, they are bullions, coins and jewelry.

Historically only very few investments have rivaled gold in its popularity as a hedge asset against almost any kind of problematic situation on the investment markets, starting with inflation, to economic dislocation or currency volatility, to war and any geopolitical earthquake we are currently living. When you think about investing in gold, you don't have to restrict yourself to simply buying physical gold, like coins or bullion. Alternatives to invest in gold include buying shares of gold mining companies or gold Exchange Traded Funds (ETFs). Investors can also invest in gold by trading derivative contracts obviously, but a product which takes the lead, if it is properly and professionally structure, is a fixed income note with physical gold as the underlying asset.

The primordial part of the deal is to understand how your invested money will help the country you invest in and its population. ESG principles and the 17 Sustainable Development Goals of the United Nations, take all their importance and became tangible. What do you have to understand when you invest in physical gold are the steps of the whole process between the subscription you've done to the final product sold on the market, creating the income for each investor. We need to integrate the fact that investing "money for money" era has ended five years ago, when the financial industry itself comprehended the evidence that we only have one planet.

- Gold Bullion
When most people think about investing in gold, bullion is what they think of, a big massive gold bar locked away in a vault. Gold bullion comes in bars and it's commonly available as 12,4kg or 1kg bars. Given that the current gold price is around $1,852 per ounce (as of May 2022), this makes investing in gold bullion an expensive proposition. And unlike stocks, there is no possibility to get a fractional piece of a gold bar, unless the investment is a tailor made, like a fixed income note for example. A summarized presentation of the process, including the involved parties and jurisdictions in terms of production, refinery and sale transactions, are available upon request at Thales Solutions. But how does it concretely and technically work?

Gold bullion comes in bars of 1kg and 12,4 kg

1. Identification of the producing mines. The selection/qualification is based on 2 key criteria: known quality of brute (ore), that is a medium to high low odour of at least
2. 15 grams per ton, and best adherence to basic ESG principles as per established guidelines.
3. As per defined and signed contract, the ore is purchased with chemical testing at site to confirm the quality (value) on a pricing per LBMA daily fix price). It is then transported in secured lorries to relevant plants.
4. The ore/brute is crushed, further processed and ultimately manufactured as dore bars (85% gold purity and above but less than bullion grade).
5. The dore is then transported by global logistic partners (Hermes/Brinks) for export via the same logistics companies' aircrafts to United Arab Emirates (UAE).
6. The dore is cleared at UAE's customs by the same or another international logistics and transported to one of the 3 LBMA approved refineries for refining into bullions.
7. The bullion (99.99% of purity) as per LBMA's good delivery lists is sold into the market.

These operations are always hedged either by physical gold, the production of the ore itself or even crypto assets recently. Subscriptions in crypto are accepted by some promoters, with whom we at Thales Solutions, are currently working.

Investment Strengths:
- Accent is exclusively concentrated on protection against negative real rates, inflation, market valuations and complacency.
- Exposure to the sovereign risk of the gold mines jurisdiction
- Semi-annual payment of coupon rate with purchase possibility of underlying asset
- Risk-adjusted returns enhanced over some Physical Gold ETC by 11-12% for the last two years.

Investment Risks:
- Volatility of gold value – Moderate to high risk
- Illiquidity of instrument - Strictly limited risk
- Sovereign Credit Risk – Moderate (if selected jurisdiction is part of the stable South American states)
- Legal risk – Strictly limited

Current price per ounce is USD 1,852

- Gold Coins
The most common gold coins weigh one or two ounces, though half-ounce and quarter-ounce coins are also available. Collectible coins, such as South African Krugerrands, Canadian Maple Leafs and American Gold Eagles, are the most widely available type of gold coins. Gold coin prices may not entirely align with their gold content. In-demand collectable coins frequently trade at a premium.

- Gold Jewelry
Investors may also opt to buy gold they can wear in the form of gold jewelry, sometimes with sentimental and often financial value. Investing in gold jewelry, however, hides some risks that investing in pure gold does not contain. The primordial part here is to carefully select the jewelry purchases process and involved agents, as not all second-hand jewelry is sold by reputable counterparties. Authenticity is the key, as it's an asset which will be definitely resold once gold price reaches a certain limit, investors determined preliminarily.

An amount of markup will be required, based on which company designed and manufactured the jewelry. The bracket here is quite large and may be comprised between 20% to even more than two to three times the gold raw value.

Jewelry's purity, or what percentage gold does it contain is another main point which needs to be covered. Gold purity is calculated based on karats, with 24 karats being 100% gold. Lower purity decreases the piece's melt value and the possibility for it to be sold afterwards. According to Forbes and a recent analysis of their advisory team, some extra choices are available, giving a certain flexibility in the gold investment. Namely, stocks in gold mining companies, ETFs and derivatives, all of those possibilities we develop below.

- Invest in Gold by purchasing stocks in gold mining companies
Investing in the stock of companies that mine, refine and trade gold is a much more direct proposal than buying physical gold. Since this means buying the stocks of gold mining companies, investors can invest using their brokerage or bank accounts, Forbes advised. Investor needs to keep in mind, that the shares of stock of gold mining companies are strongly correlated with gold prices but also are related to basics of each company's current profitability, capital and liabilities, concretely their financial statements. The latter brings us to a conclusion that investing in individual gold companies roughly carries similar level of risk than investing in any stock on the market. Single stocks may experience a serious level of volatility and do not provide their investors with the security of diversified funds or other alternative asset vehicles.

- Invest in Gold ETFs and Gold Mutual Funds
Investing in gold ETFs and mutual funds can provide investors with exposure to gold's long-term stability, offering simultaneously more liquidity than physical gold holdings and more diversification than individual gold stocks. Strategies can include passively managed index funds that track industry trends or the price of gold bullion using derivative products. Actively managed funds, on the other hand, aim to over perform the returns of passively managed index funds. Expenses are at a very high level as an exchange of that. In such gold investments, the purchased asset is a document backed by debt or equity of mining companies or futures and options contracts for physical gold bullions. This means the value of gold mutual funds and ETFs may not entirely match up with the market price of gold, and these investments may not perform the same as physical gold, especially in a rally period.

- Derivative products to invest in Gold
This is by all means the riskiest way, as trading derivatives is a certain a form of speculative investing. As futures contract is an agreement to buy or sell the underlying asset for a determined price on a certain date, independently of the current market situation, it hides an immeasurable risk for the finances of the investor. An options contract, meanwhile, is an agreement that gives you the option, but not the obligation, to purchase or sell the underlying asset, which is the gold in our case, if it reaches a certain price on or before a certain pre-defined date.

People who choose to invest in gold via options or futures contracts need to actively monitor their holdings so they can sell, roll over or exercise their options before they expire worthless. In addition, each of these derivative products includes a certain degree of leverage, or debt, non negligible by default, so investors who overuse them and experience market losses can see their losses climb quickly and exponentially.