Principles for Responsible Investment

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Dear Ms. Berger,

Re: Revision to the Institutions for Occupational Retirement Provision (IORP) Directive

About the PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI represents 1500 signatories globally with $60 trillion in assets under management. In Europe, 790 signatories have signed the Principles, of whom 174 are asset owners.

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and the long-term health and stability of the market as a whole. It is driven by a growing recognition in the financial community that evaluation of ESG issues is a fundamental art of assessing portfolio value and investment performance.

Background

On 25 January 2016, the ECON committee of the European Parliament approved a draft text that requires IORPs to;

- Produce a risk evaluation covering ESG risks, including climate risk and risk related to the depreciation of assets due to regulatory change ('stranded assets'). This should be appropriate to the size and internal organisation of the fund, as well as the nature, scale and complexity of their activities;
- Ensure that a governance system is in place such that ESG issues are a part of investment decision making, and;
- Disclose how ESG issues are considered via the Statement of Investment Policy Principles.

The text also clarified that the prudent person principle, a key investor duty, does not prevent institutions from taking the environmental, social, governance or ethical factors into account. The draft text is provided as an accompaniment to this letter.

Summary of PRI's position

Firstly, the draft text will help to meet the EU's objectives of improving governance and transparency of occupational pension funds. They will ensure that IORPs review a comprehensive range of risks, appropriate to the nature, scale and complexity of the fund, and in doing so provide better investment outcomes to scheme members and beneficiaries. They will strengthen and harmonise existing pension fund regulation around ESG factors in Europe, and in doing so bring Europe in line with domestic and international best practice.

Secondly, PRI's experience is that funds can embed ESG issues into existing processes, such as manager selection, in a cost-effective and efficient manner. Furthermore, the draft text allows flexibility for the fund to determine an appropriate level of due diligence, given the nature, scale and complexity of their activities. Industry organisations, such as the PRI, support funds to embed ESG analysis into investment practice at low cost. On emerging issues such as portfolio climate exposure stress testing, PRI and investors are working with the Financial Stability Board's climate task force.

Finally, by clarifying the prudent person principle, this Directive will address a common barrier to better consideration of ESG issues – the perception that investor duties prevent funds from considering ESG factors.

For these three reasons, PRI recommends;

1. **The Council should support the ECON committee's amendments to recital (41) and articles 22, 26, 29 and 32.**

2. **The Council should clarify that the *prudent person principle* requires asset owners to pay attention to long-term factors, including ESG factors, in investment decision making and the decision-making of their agents.**

3. **The EU and Member States should support regulators to effectively supervise the Directive. Best practice sharing between regulators should be encouraged.**

Evidence for PRI's conclusions

Considering ESG risks is best practice

The revision of the IORP Directive is designed to protect scheme members and beneficiaries, through establishing higher standards of governance and transparency.

These objectives can only be met if IORPs evaluate the materiality of ESG risks, amongst others. An increasing body of expert analysis[1], academic evidence[2], and recent examples such as the Volkswagen scandal demonstrate that environmental, social and governance issues present real, material risks to scheme members and beneficiaries.

ESG issues are dynamic, and their relevance may vary with the investment style, location and time horizon of an investor[3]. Not every issue will be material to every investor. The draft text recognises this, by giving flexibility to investors to establish a risk evaluation appropriate to the size and internal structure of the fund, and the nature, scale and complexity of its activities.

Through PRI's experience of engaging with funds of all sizes, we have identified a perception that considering ESG issues is costly and difficult for small funds. PRI's experience is that responsible investment can be integrated into mainstream investment practice[4], and is therefore accessible to small funds. This is reflected in PRI's own signatory base – a third of PRI's asset owner signatories manage less than €2bn, and many do not have full time staff. These funds establish their view on the materiality of ESG issues and reflect these through mandate design and investment consultant selection[5].

Investor duties, such as the prudent person principle, are often cited by investors as a reason they cannot take a proactive approach to considering ESG issues in investment decision making[6]. In 2015, PRI and the UN Environment Programme Finance Initiative[7] conducted extensive research with asset owners, lawyers and policy makers, which found that failing to consider long-term investment value drivers, including material ESG factors, in investment practice is a failure of investor duties. This is consistent with the DG Environment's recent report into *Resource*

Efficiency and Fiduciary Duties of Investors. We welcome the intended clarification of the prudent person principle (article 20, 1aa), but believe that the text should instead state:

(aa) the 'prudent person' rule requires investors to consider long-term investment value drivers, including material ESG factors, in investment decision making and the decision making of agents.

Precedent exists in many European markets, but protection for beneficiaries varies

The draft text would ensure that beneficiaries and scheme members across Europe benefit from ESG factors, building on and strengthening existing regulation in the Netherlands, France, the UK, Germany, Austria, Italy, Denmark, Belgium and Sweden[8]. They would bring the EU in line with international good practice[9], such as South Africa's, Pension Funds Act (1956, revised 2011), which defines prudent investing as giving appropriate consideration material E, S and G issues, or the US Department of Labor's October 2015 bulletin which clarified that ESG integration is consistent with investors' fiduciary duties, and should therefore form part of an investor's primary investment analysis.

Next steps

The PRI has engaged with the European Commission on the Non-Financial Reporting directive, the Shareholder Rights directive, and contributed to the DG Environment's recent report, Resource Efficiency and Fiduciary Duties of Investors. The PRI has also followed the implementation of the IORP directive, Solvency II, the Markets in Financial Instruments Directive and the Long-term Investment Fund Regulation. The PRI has experience in ESG regulation and implementation in a number of investment markets, and offers its expertise to the Council, Commission and Parliament to support strong implementation of the revised IORP Directive.

Yours sincerely,

Fiona Reynolds

Managing Director

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APPENDIX: FULL TEXT OF AMENDMENTS

Recital

(41) It is essential that institutions improve their risk management ***taking into account the objective of ensuring the intergenerational balance of the pension scheme,*** so that potential vulnerabilities in relation to the sustainability of the pension scheme can be properly understood and discussed with the competent authorities. Institutions should, as part of their risk management system, produce a risk ***assessment*** for their activities relating to pensions. That risk ***assessment*** should also be made available to the competent authorities ***and should include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')***

Article 20

Investment rules

1. Member States shall require institutions located in their territories to invest in accordance with the 'prudent person' rule and in particular in accordance with the following rules:

> (a) the assets shall be invested in the best ***long-term*** interests of members and beneficiaries ***as a whole***. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;
>
> ***(aa) the 'prudent person' rule shall not prevent institutions from taking into account the potential long-term impact of investment decisions on environmental, social, governance or ethical factors;***

PRI's view is that the above clause should instead state:

> ***(aa) the 'prudent person' rule requires investors to consider long-term investment value drivers, including material ESG factors, in investment decision making and the decision making of agents;***

Article 22

General governance requirements

1. Member States shall require all institutions to have in place an effective system of governance which provides for sound and prudent management of their activities. That system shall include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. The system of governance shall be subject to regular internal review. ***The system of governance shall require environmental, social and governance factors related to investment assets to be considered in investment decisions, shall involve relevant stakeholders and shall be subject to regular internal review.***

Article 26

Risk management

1. Member States shall require institutions***, in a manner that is appropriate to their size and internal organisation, as well as the nature, scale and complexity of their activities,*** to have in place an effective risk-management system comprising strategies, processes and reporting

procedures necessary to identify, measure, monitor, manage and report on a continuous basis ***to competent authorities*** the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.

That risk-management system shall be ***effective and*** well-integrated into the organisational structure and in the decision-making processes of the institution.

2. The risk-management system shall cover appropriately to their size, internal organisation and the nature, scope and complexity of their activities risks which can occur in the institutions or in undertakings to which tasks or activities have been outsourced at least in the following areas:

(a) …

(fa) ***social and environmental risks relating to the investment portfolio and the management thereof***.

Section 3

Documents concerning governance

Article 29

Own risk assessment

1. ***As*** part of ***its*** risk-management system, ***and in a manner that is appropriate to its size and internal organisation, as well as to the nature, scale and complexity of its activities, every institution shall conduct its*** ▌own risk assessment ▌.

The risk ***assessment*** ▌shall be performed regularly and without delay following any significant change in the risk profile of the institution or of the pension ***schemes operated by the institution***.

2. The risk ***assessment*** referred to in paragraph 1 shall cover***, where appropriate to the nature, scale and complexity of the institution's activities***:

(a) …

(h) ***an*** assessment of new or emerging risks***, including risks related*** to climate change, use of resources and the environment***, social risks and risks related to the depreciation of assets due to regulatory change***.

Article 32

Statement of investment policy principles

Member States shall ensure that every institution located in their territories prepares and, at least every three years, reviews a written statement of investment-policy principles. That statement is to be revised without delay after any significant change in the investment policy. Member States shall provide for this statement to contain, at least, such matters as the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities ***and how the investment policy takes environmental, social and governance issues into account. The statement shall be made publicly available on a website***.

REFERENCES

1. Examples include:

    a. De Nederlandsche Bank (2016) *Tijd Voor Transitie - een verkanning van de overgang naar een klimaatneutrale economie / Time for transition – an exploration of the transition to a low carbon economy*, which found, through a survey of pension fund policies, that Dutch pension funds are aware of, and planning to manage risks associated with climate change.

    b. European Systemic Risk Board (2016): Too late, too sudden – transition to a low carbon economy and system risk estimates that European investors could lose up to €400bn if climate risk is not managed in an appropriate and timely manner.

    c. On the request of G20 Finance Ministers and Central Bank Governors, the Financial Stability Board has convened a task force to consider the physical, liability and transition risks associated with climate change.

2. Examples include:
    a. Gunnar Friede, Timo Busch & Alexander Bassen (2015) *ESG and financial performance: aggregated evidence from more than 2000 empirical studies* finds that in 62% of studies evaluated, companies with positive ESG characteristics have superior financial returns, and over 90% exhibit a non-negative relationship between positive ESG characteristics and financial returns.
    b. Smith School of Enterprise and the Environment, Arabesque Asset Management: From the stockholder to the stakeholder: how sustainability can drive financial outperformance. The study finds that 90% of studies show that sound sustainability standards lower cost of capital for companies, 88% show that solid ESG practices result in better operational performance of firms and 80% of studies show that stock price performance of companies is positively influenced by good sustainability practices.

3. PRI and UNEP Finance Initiative (2015): *Fiduciary Duty in the 21st Century* (p. 12-13)

4. PRI (2016): *Beliefs to mandates: How asset owners can drive responsible investment*

5. PRI (2011): Implementation of the Principles for Responsible Investment by small and resource constrained investors.

6. PRI and UNEP Finance Initiative (2015): *Fiduciary Duty in the 21st Century* finds that failing to consider long-term drivers of value creation, such as ESG factors, is a failure of fiduciary duty.

7. PRI (2016): *Beliefs to mandates: How asset owners can drive responsible investment* identifies a misconception that investor duties, and in particular fiduciary duty, prevents investors from taking a proactive approach to responsible investment.

8. European examples of pension fund regulation and initiatives regarding ESG issues:

a. **France**: Article 173 of the Energy Transition Law (2015) requires institutional investors to disclose information on their general approach to ESG issues, investment policy and risk management including any relevant ESG risks identified, and an explanation for ESG criteria partially or not considered. Investors must also provide assessment of physical climate risk and transition risk (exposure to changes caused by the transition to a low carbon economy) and an assessment of the fund's contribution to meet the international target to limit climate change and the French low carbon strategy's carbon budgets.
b. **Netherlands**: Pensioenwet (2015) requires pension funds to invest in accordance with the prudent person rule, including stating in their annual report how their investment policy takes environmental, climate, human rights and social issues, indicating that the two considerations are consistent. The Federation of the Dutch Pension Funds and Dutch Labour Foundation's Pension Fund Code (2014) requires pension funds to define a Responsible Investment strategy and make this available for stakeholders. Furthermore, the pension fund should take shareholder interests into account and make sure stakeholders support the investment strategy at hand. Compliance is on a "comply or explain" basis, with annual reporting on application. In November 2015, the Dutch Pensions regulator De Nederlandsche Bank (DNB) initiated a review of ESG investment policies amongst Dutch funds, with results incorporated into the regulator's practice for assessing financial and reputational risk.
c. **United Kingdom**. The UK's Occupational Pension Schemes (Investment) Regulations state that a UK pension fund's Statement of Investment Principles (SIP) must cover "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments".
d. **Germany**: Act on the Supervision of Insurance Undertakings (2005) requires pension funds to inform entitled employees prior to the conclusion of the contract and subsequently on annual basis, if and how ESG issues are considered in investment decisions.
e. **Italy**: Legislative Decree "Disciplinadelleforme pensionistiche complementari" (2005) requires pension funds to disclose, via the annual report, whether and to what extent ESG influences investment decisions and the exercise of voting rights.
f. **Austria**: Pensionskassengesetz/ Pension Fund Act (2005) requires pension funds to disclose whether an ESG investment approach is taken.
g. **Denmark**: Act Amending the Financial Statement Act (2012) mandates Investors to disclose information on corporate social responsibility, implementation methods and evaluation of achievements.
h. **Belgium**: Law of April 2003 (Law on Supplementary Pensions/Vandenbroucke Law) requires mandatory disclosure by supplementary pension schemes in annual reports on the degree to which social, environmental and ethical criteria are considered in investment strategy. Law of July 2004 requires mandatory disclosure by Collective Investment Schemes in annual reports on degree to which social, environmental and ethical criteria are considered in investment strategy.
i. **Sweden**: National Pension Insurance Funds (AP Funds) Act (2002, amended 2008) requires the AP funds to take environmental and ethical considerations into account without relinquishing the overall goal of a high return on capital. New rules for the AP Funds (2014) requires AP funds to give attention to promotion of sustainable development, without compromising the Prudent Person Principle.

9. International examples of pension find regulation or fiduciary duty clarification regarding ESG issues:
    a. **United States:** In October 2015, the US Department of Labor issued a bulletin clarifying that ESG integration is consistent with investors' fiduciary duties, and should therefore be part of an investor's primary investment analysis.
    b. **Australi**a: Corporations Act (2001) requires superannuation funds to disclose "the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment". Financial Services Council's Standard on Superannuation Governance Policy (2014) requires superannuation funds to develop a policy setting out how they address ESG issues.
    c. **Canada**: Ontario Pension Benefits Act (2016) requires pension funds to disclose in their investment policies "information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated".
    d. **South Africa**: The Pension Funds Act (1956, revised 2011) states: "Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment."
    e. **South Korea**: The National Pensions Service Act (2015), requires Korea's KRW 470 trillion (€300bn) National Pension Scheme to incorporate ESG factors into investment decision making.