PRI | Principles for Responsible Investment

EUROPEAN COMMISSION

PUBLIC CONSULTATION ON LONG-TERM AND SUSTAINABLE INVESTMENT

INTRODUCTION TO PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. PRI has 1500 signatories globally with €53 trillion ($60 trillion USD) in assets under management. In Europe, there are 790 signatories. We welcome the opportunity to contribute to the European Commission's public consultation on long-term and sustainable investment.

PRI signatory investors are required to report publicly on their responsible investment activities. PRI's website hosts over 1,000 public responses, detailing how investors consider ESG factors in their investment decision making, active ownership, and engagement with the wider investment community and policymakers. It is analysis of this evidence base, along with ongoing dialogue with responsible investment practitioners, that forms the basis of PRI's response to this consultation.

SUMMARY OF PRI'S RESPONSE

The PRI has been at the forefront of huge growth in responsible investment since it was founded in 2006. Much of this growth has happened in Europe, and many European investors have adopted leading practices. However, this still falls short of what is needed to finance the European Union's 2020 policy objectives and the 2030 Sustainable Development Goals. To achieve these objectives, institutional investors need to fully incorporate ESG factors into investment decision making, stewardship and engagement with the wider investment community and policy makers.

As we demonstrate through our response to this consultation:

1) A number of barriers exist which prevent a fuller consideration of ESG factors by institutional investors. These issues are cross-cutting and touch on many different areas of the Commission's remit.
2) A systematic approach is needed to ensure all relevant regulation and market oversight are aligned in support of long term, sustainable investment.

Therefore, the **PRI recommends that the European Commission develop and publish an action plan to remove barriers to long-term, sustainable investment**.

Barriers include:

- **Policy:** Lack of clarity on the extent to which policymakers prioritise ESG issues. Absence of supportive, stable, harmonised policies, and lack of clarity regarding investor duties such as fiduciary duty.
- **Capacity and understanding:** Lack of skills and capacity for ESG analysis and incorporation into investment strategies.
- **Data provision:** Lack of consistent, comparable, action-oriented data on how ESG factors are incorporated in a company's long term value creation prospects.

- **Investment opportunities:** Availability of investment products that meet the needs of responsible investors.
- **Misaligned interests:** A need to strengthen alignment between the interests of the owners of capital and the interests of those making day to day investment decisions.
- **Market structures:** Issues such as short-termism and the ensuring pension funds have the resources to hold their service providers to account on ESG integration.
- **Advisory issues:** Analysis and recommendations from advisory firms often omit ESG factors.

The action plan should link to existing initiatives, such as the Capital Markets Union, the Shareholder Rights Directive, the Non-Financial Reporting Directive and revision of the Institutions for Occupational Retirement Provision (IORP) Directive, and should encompass dialogue with leading investors across Europe. The action plan should include the role investors can play through stewardship and public policy engagement in addition to direct financial contributions.

The PRI has experience in ESG regulation in a number of international investment markets, and has developed a wealth of practical guidance on incorporating ESG factors into investment decision making, reflecting the operational experiences of signatories. PRI offers its expertise to support the European Commission to ensure the outcomes of this consultation are well-implemented, reflect existing good practice and remain current.

CONTACT

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CONSULTATION QUESTIONS

PRI is providing a response to questions **1** (a, b), **2** (a, b, c, i), **3** (a, b), **4** (a), **5** (a, b), **6** (a, b, c), **7** (c, d, e, f), **9** (a, b), **10** (a), consistent with the PRI's six Principles and existing PRI reports and research.

1. RATIONALE FOR ESG INCLUSION INTO INVESTMENT DECISIONS

1.a. Do ESG factors play a role in the investment decisions of investors? If not, why? If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

Do ESG factors play a role in the investment decisions of investors?

Analysis of PRI data demonstrates a substantial community of investors in Europe working to integrate ESG factors. Of the 521 European Signatories reporting to PRI in 2015 (1), 485 (93%) hold a responsible investment policy. However, depth of implementation varies. Some investors have fully developed processes for considering evolving ESG factors as a core part of strategy development, investment decision making and active ownership. However, others are at an early stage of development, or facing barriers to more thorough implementation directly or via external managers and service providers (2). Implementation also varies across asset classes, with ESG incorporation reported more frequently in listed equity than other asset classes.

PRI signatories represent around €53tn ($60tn USD) in assets under management, approximately half of the global institutional investment market. PRI works with signatories to put responsible investment into practice, and to identify and remove barriers to mainstreaming RI practices. We believe that more work is needed to remove barriers to integration of ESG factors, including more concerted action from policy-makers.

If not, why?

PRI believes that asset owners are uniquely positioned to drive responsible investment. While we note the considerable efforts taken by some asset owners, the scale and depth of implementation is in many cases missing. For example, PRI finds that while the majority of asset owners consider ESG factors to some extent in manager selection, only a minority assign a specific weighting to ESG factors in their evaluation (2). This weak implementation sends signals to the market as a whole that responsible investment is not a priority for asset owners, which in turn limits the willingness of investment consultants and investment managers to consider ESG factors in their advice and products.

Our research (3) finds five distinct barriers to asset owners taking a more proactive approach to responsible investment:

- The perception that ESG issues do not add value to investment decision-making.
- The perception that significant additional resources are required to implement responsible investment.
- The perception that investor duties, and in particular, fiduciary duty, prevents investors from taking a proactive approach to responsible investment.
- The advice given by investment consultants, which is often seen as not supporting proactive approaches to responsible investment.
- The products provided by investment managers, which often do not meet the responsible investment needs of asset owners.

The PRI offers solutions to these barriers in the publication referenced above.

Some additional examples affecting the wider investment chain include capacity and skills, absence of clear and consistent policy signals, misinterpretation of fiduciary duty, data provision, misaligned interests between participants in the investment chain and short-termism.

Which considerations are reflected in investment policies and mandates?

Investors looking to implement a responsible investment strategy must start by developing their beliefs on responsible investment and the relevance of ESG factors to their investment governance, and then look to build these into investment mandates. Analysis of reporting framework data finds that the most common ESG clause in investment mandates is a requirement to invest in line with the asset owner's investment beliefs – but these beliefs typically lack sufficient detail or specificity (2). The publication referenced above presents a series of model clauses for investment mandates. PRI would encourage the European Union to consider model mandate clauses for occupational pension funds.

References

1) Reporting to PRI becomes mandatory after a one year grace period, meaning the number of respondents is lower than the total number of European signatories noted in our introduction
2) PRI (2015): [Report on Progress]
3) PRI (2016): [How asset owners can drive responsible investment – beliefs, strategies, mandates]

1.b. What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues (multiple choice)

- **a) risk management:**
  - **i. managing asset value risk in the short term, including preservation of investment value, better investment performance**
  - **ii. Managing asset value risk in the medium to long term, mitigation of exposure to long-term and systemic risks**
  - **iii. Management of liability risks**
- **b) alignment of investment policies with the long-term interests of beneficiaries of the institutional investor,**
- **c) pressure from clients on whose behalf the institutional investor invests funds,**
- **d) seeking a positive social or environmental impact of investments,**
- **e) ethical considerations,**
- **f) legal or regulatory constraints, please specify,**
- **g) other, please specify.**

Please provide an explanation :

All of the above issues are reasons for institutional investors to consider ESG factors in investment decision making. These reasons are not mutually exclusive, and will impact different participants in the investment value chain in different ways.

In response **to f) *legal and regulatory constraints*,** we are aware of regulatory initiatives which prevent investors from investing in certain sectors or countries, such as the convention on cluster munitions, trade embargoes or sanctions. However, legal and regulatory frameworks can also provide a positive impetus for action without constraining an investor's activity. Examples from EU Member States include:

- France's *Energy Transition Law (2015)* which requires institutional investors to disclose information on their general approach to ESG issues, if and how they are integrated into investment policy and risk management approach, and resulting analysis and investment decisions. They must also assess their contribution to international climate targets.

- Requirements for pension funds to disclose if, and how, ESG issues are factored into investment processes in the UK (*Occupational Pension Schemes (Investment) Regulations),* the Netherlands (*Pensioenwet (2015)*), Germany (*Act on the Supervision of Insurance Undertakings (2005*)), Italy (*Legislative Decree "Disciplinadelleforme pensionistiche complementari" (2005)),* Austria (*Pensionskassengesetz/ Pension Fund Act (2005)*) and Belgium (*Law of April 2003 (Law on Supplementary Pensions/Vandenbroucke Law) and Law of July 2004*).
- Requirement for the Swedish AP funds to take sustainable development into account, without compromising their overall goal of high return on capital *(AP funds Act (2002, amended 2008)* and *New Rules for AP Funds (2014)).*

We also note two particularly relevant international examples:

- 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.
- South Africa's Pension Funds Act (1956, revised 2011) explicitly requires investors to consider ESG factors as part of their investment analysis. The text 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."

In response to **g) Other, specify**, we believe the following are also drivers:

- Better risk-adjusted returns, through better understanding of a company's long-term value drivers.
- Soft-law initiatives such as the OECD Guidelines for Multinationals and the UK's Stewardship Code
- High profile events such as COP 21, which stimulated wider awareness of the role of investors in the transition to a low carbon economy
- International initiatives such as the Principles for Responsible Investment, the UN Environment Programme Finance Initiative and the UN Global Compact

2. INFORMATION ON ESG RISKS AND OPPORTUNITIES

2.a. Which ESG risks do you perceive as material to investors?

Materiality is a dynamic concept, and the materiality of ESG issues evolves over time. This evolution is driven by changes in legislation and policy, by changes in risk and the understanding of risk, by changes in the social, environmental and economic impacts of the ESG issue in question, and by changes in societal (and beneficiary) expectations and norms. Investors should establish a robust process for determining which ESG risks are material, based on credible assumptions.

To give some examples of relevant issues, the following were identified through a PRI 2015 consultation with 55 PRI signatories, designed to identify priorities for collaborative engagements:

- Climate Change
- Water risk
- Deforestation
- Rare earth minerals and environmental degradation

- Supply chain labour standards
- Human rights
- Income inequality and disparity of wealth within societies
- Cybersecurity
- Corporate tax responsibility
- Anti-corruption
- Director nominations
- Political activities
- Risk management and culture at banks

2.b. What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

A range of different data sources are used by investors to identify, understand and act on emerging ESG issues. Examples include:

- Analysis and engagement from civil society and the media.
- Research and statements from international bodies such as the IPCC, OECD's Financial Stability Task Force (1) and the European Systemic Risk Board (2).
- Reports and information sharing sessions from industry associations, such as PRI or the Global Investor Coalition on Climate Change.
- Information received directly from the companies, through reporting and dialogue. Raw ESG data and ratings are provided in some data analytics packages.
- Analysis produced by service providers such as brokers, research firms, rating agencies, engagement overlay providers and/or proxy advisory firms.

For asset owners, ESG information will help them to identify material ESG issues and understand how these relate to their investment beliefs. However, when selecting and appointing managers, they require information on how the investment manager will consider ESG factors. At present, the main sources for this information are questions on responsible investment in requests for proposals, investment consultant advice, SRI fund labels and data from the PRI Reporting Framework.

Looking at investment research specifically, the PRI Reporting Framework finds that European investors use a range of different providers, including dedicated research providers, sell-side providers and in-house via specialised ESG research functions or mainstream analysts. The most common type of data sourced is company-related analysis or ratings, though a substantial number of investors also source raw ESG data, sector, country or ESG-issue analysis or screened stock lists. More investors source research from external advisors than in-house. Please see the attached charts (3).

References

1) Financial Stability Board (2016): Press release: FSB announces membership of Task Force on Climate-related Financial Disclosures
2) European Systemic Risk Board (2016): Reports of the Advisory Scientific Committee: Too late, too sudden: Transition to a low-carbon economy and systemic risk
3) PDF attachment: PRI Reporting Framework responses Q 2b.

2.c. Is it difficult for investors to access such information? If so, please specify:

As noted in our response to 1.a, availability of information is a barrier to more thorough incorporation of ESG issues into investment processes.

ESG factors can have a material impact on a company's value creation prospects, and as such should be considered a core part of a company's communication to investors. Information should clearly and concisely communicate how an organisation's "strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term" (1).

Such information should be treated consistently with traditional financial reporting. PRI welcomed the EU's recent Directive on Non-Financial Reporting, but notes that the following remain issues:

- Timing: Companies should treat material ESG information as market sensitive and disclose it in a timely manner.
- Usefulness: Information should be made available in a format which allows investors to take action. Forward-looking data is important. Clear links should be made between sustainability initiatives and the firm's long-term value creation prospects.
- Reliability: The company should provide details of steps taken to ensure the fairness, balance and veracity of the information reported.
- Availability: Less data is typically available for medium and smaller-sized companies and regional coverage also varies, with more data typically available for companies in developed markets.

References

1) International Integrated Reporting Council: International <IR> Framework

2.d. Is access to such data expensive? If so, please specify:

No PRI Response

2e. What factors may prevent or discourage companies from disclosing such data?

No PRI Response

2.f. What is the main rationale for companies to publish such information? Please indicate all the relevant issues. (multiple choice)

a) relevance of ESG issues to company performance
b) attracting financing for specific projects, for example green bonds
c) legal or regulatory constraints
d) demand from investors
e) pressure from stakeholders
f) other

No PRI Response

2.g. Is there sufficient accountability for the disclosure by companies of such information?

No PRI Response

2.h. What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

No PRI Response

2.i. What is the role of specific ESG investment instruments, like green bonds?

ESG investment instruments deliver an attractive combination of financial return and sustainability outcomes, and have an important role to play in driving investment towards much-needed environmental and social outcomes. PRI welcomes the continued growth in allocation to SRI funds. However, PRI also encourages investors to investigate the potential significance of a range of ESG issues for all investments, recognising the impact ESG issues have on long term risk-adjusted returns.

3. INTEGRATING ESG INFORMATION INTO RISK ASSESSMENT MODELS OF INSTITUTIONAL INVESTORS AND ASSET MANAGERS

3.a. What should an appropriate long-term risk assessment methodology look like? Please indicate some examples of good practice.

PRI's publication "Integrated analysis – how investors are addressing environmental, social and governance factors in fundamental equity valuation" details different analytical approaches for incorporating ESG factors into listed equity investments - economic analysis, industry analysis, company strategy, analysis of financial reports and valuation tools (1). PRI will publish an updated study of market practice later in 2016.

PRI has also published two papers on ESG risk for fixed income investors (2), (3) and elaborated on methodologies through our investor guide for fixed income (4) and case studies (5).

References

1) PRI (2013): Integrated analysis – how investors are addressing environmental, social and governance factors in fundamental equity valuation
2) PRI (2013): Corporate Bonds: Spotlight on ESG risks
3) PRI (2013): Sovereign bonds: Spotlight on ESG risks
4) PRI (2014): Fixed Income investor guide
5) PRI (2014 onwards) Fixed Income case study series. Examples include: The impact of energy and climate on sovereign risk, screening and engaging to mitigate ESG risks, the business case for considering ESG dynamics in sovereign bonds, quantifying the impact of more strictly enforced environmental regulation.

3.b. Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

PRI research (1) finds that even though many asset owners have made commitments to responsible investment, the majority have yet to ensure that these are effectively implemented. There are inconsistencies in investment practices in different asset classes, high-level statements on sustainability or environmental, social and governance issues are often missing from investment beliefs, and responsible investment commitments are not embedded in investment mandates.

This creates a multiplier effect throughout the investment market. Weak implementation of responsible investment by individual asset owners sends signals to the investment market as a whole that responsible investment is not a priority for asset owners. In turn, this limits the willingness of investment consultants and investment managers to focus on responsible investment and ESG issues in their products and in their advice.

This can be addressed by asset owners increasing scale (number of asset owners explicitly considering ESG factors) and depth (the extent to which ESG factors are embedded within manager selection and monitoring processes). As noted in question 1.a, our research has identified the following barriers:

- The perception that ESG issues do not add value to investment decision-making.
- The perception that significant additional resources are required to implement responsible investment.
- The perception that investor duties, and in particular, fiduciary duty, prevents investors from taking a proactive approach to responsible investment.

- The advice given by investment consultants, which is often seen as not supporting proactive approaches to responsible investment.
- The products provided by investment managers, which often do not meet the responsible investment needs of asset owners.

The PRI proposes solutions to these barriers in "*How asset owners can drive responsible investment – beliefs, strategies and mandates*".

Some additional examples affecting the wider investment chain include capacity and skills, absence of clear and consistent policy signals, misinterpretation of fiduciary duty, data provision, misaligned interests between participants in the investment chain and short-termism.

References

1) PRI (2016): How asset owners can drive responsible investment – beliefs, strategies, mandates

4. INTEGRATION OF ESG ASPECTS IN FINANCIAL INCENTIVES

4.a. When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies? What are the best practices in this area?

As noted in our response to 3.b, PRI research finds that even though many asset owners have made commitments to responsible investment, the majority have yet to ensure that these are effectively implemented. There are inconsistencies in investment practices in different asset classes, high-level statements on sustainability or environmental, social and governance issues are often missing from investment beliefs, and responsible investment commitments are not embedded in investment mandates (1).

PRI recommends that asset owners should integrate sustainability factors in the selection process for investment managers by:

- Reviewing the investment manager's investment beliefs or philosophy;
- Assessing the ESG skills of all investment staff;
- Setting out ESG reporting expectations;
- Issuing investment mandates with ESG integration and reporting requirements, including on stewardship activities and turnover, with fees and pay structures that support ESG performance;
- Assigning specific weight to ESG factors in investment manager and investment consultant appointment.

PRI recommends that investment mandates should require investment managers to:

- Implement the asset owners' investment beliefs and relevant investment policies;
- Integrate ESG issues into their investment research, analysis and decision-making processes;
- Invest in a manner consistent with the asset owner's time horizons, understanding the key risks that must be managed to achieve the asset owner's portfolio goals;
- Implement effective stewardship processes, including engagement with companies and issuers on ESG issues and, for listed equities, voting all shareholdings – this engagement should align with the asset owner's responsible investment and related policies;
- Engage constructively and proactively with policy makers on responsible investment and ESG-related issues – this engagement should align with the asset owner's responsible investment and related policies;

- Report on the actions taken and outcomes achieved – the reporting should enable the asset owner to assess the manner in which the investment manager has implemented the asset owners' investment beliefs and policies, and to understand how this has affected investment performance and ESG outcomes and impacts.

PRI recommends that asset owners integrate ESG factors in the monitoring process for investment managers and investment consultants, including:

- Reviewing the investment manager's voting processes;
- Including ESG issues as a standard agenda item at performance review meetings;
- Assessing how the investment manager incentivises research providers, including brokers, to provide ESG research;
- Assessing how the investment manager engages policy makers on ESG issues.

Incentive structures are often cited as a barrier to truly long-term investment. Analysis from Focusing Capital on the Long Term proposes that, in addition to establishing their investment horizon as part of their investment beliefs, asset owners should link incentives to that value creation horizon. Interim assessments of performance should focus on whether the portfolio is being managed consistently with agreed processes and the asset owner's investment beliefs. Further details are provided through their Long Term Portfolio Guide (2).

References

1) PRI (2016): How asset owners can drive responsible investment – beliefs, strategies, mandates
2) Focussing Capital on the Long Term (2015): Long Term Portfolio Guide

4.b. Is ESG performance and active asset ownership taken into account in the remuneration of the executives and/or board members of institutional investors? What are the best practices in this area?

No PRI Response

5. CAPACITY OF INSTITUTIONAL INVESTORS

5.a. Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

As noted in our response to question 1.a, capacity and skills do present a barrier to investors on ESG issues. Even if some teams within an organisation have high awareness and skill, segregation between specialist ESG teams and mainstream investment teams can lessen their impact.

PRI's experience is that, while challenges remain for small funds, responsible investment can be integrated into mainstream investment practices. 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 investment beliefs, mandate design and investment consultant selection (1). However, this does require awareness and commitment from the Board of Trustees.

We also note some practical issues - smaller funds are also likely to use investment consultants, whose advice often omits ESG factors from analysis and recommendations (2). Furthermore, smaller funds are more likely to invest in pooled funds, rather than via segregated mandates (3), limiting their ability to influence voting decisions or set custom parameters for ESG incorporation.

Smaller funds also find it more challenging to influence companies via voting and engagement, though collaboration can be an effective route to address this.

Resourcing is not just a problem for responsible investment. The UN Environment Programme Finance Initiative's *Inquiry into the design of a sustainable financial system* analysed second pillar pension funds in the United Kingdom and found that many of the UK's estimated 50,800 pension funds do not have the scale to deliver on beneficiary interests, including, but not limited to sustainability matters (4).

References
1) PRI (2011): [Implementation of the PRI by small and resource constrained asset owners.]
2) PRI, UNEP Finance Initiative, UNEP Inquiry and UN Global Compact (2015): [Fiduciary Duty in the 21st Century]
3) PRI Reporting Framework data 2014-15. 46% of asset owners holding < $2bn (USD) invest mainly via pooled funds, opposed to 34% of asset owners holding > $50bn.
4) UNEP FI Inquiry into the design of a sustainable financial system (2016): [Global Hub, Local Dynamics]

5.b. Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

PRI's work seeks to empower investors and build their capacity to incorporate ESG factors into their primary investment analysis. Some examples include:

- Action-oriented research on emerging ESG factors. A recent example is guidance on engaging companies on corporate tax responsibility (1).
- A collaborative engagement platform (the PRI Clearinghouse), allowing investors to pool resources and work together to engage companies and other stakeholders.
- Practical tools and guidance on establishing responsible investment policies and procedures. Examples include guidance for asset owners writing a responsible investment policy (2), incorporating ESG factors into manager selection, appointment and monitoring (3), integrating ESG factors into investment decision making (4) and implementation of responsible investment by small and resource constrained investors (5).
- The PRI Reporting Framework, which defines a global standard of responsible investment reporting, styles and terminology. All PRI signatories that manage funds are required to report how they consider ESG factors in investment decision making and active ownership, on an annual basis. Over 1,000 reports are made public on PRI's website (6), providing a peer comparison and benchmarking resource. Based on this data, PRI provides a performance assessment in the form of a score by asset class, graded from A+ to E, and individual follow up on how to develop more rigorous processes.
- Linking academic insights with responsible investment practitioners. RI Quarterly summarises RI research in an easily digestible format. Recent editions covered investment post COP 21 and the role of reporting and disclosure in driving ESG performance.
- Dedicated local networks in Continental Europe, the Nordic region, North America, Latin America, Australasia, Africa and Asia support signatories to implement the Principles in the local context and provide a platform for best-practice sharing, networking and collaboration.

PRI also works closely with a range of organisations dedicated to encouraging responsible investment. Examples include:

- *Climate Change*: the Global Investor Coalition on Climate Change (GIC), the Investor Network on Climate Risk in USA (INCR), the Institutional Investors Group on Climate

Change (IIGCC), the Investor Group on Climate Change in Australia / New Zealand (IGCC) and the Climate Bonds Initiative.

- *Corporate Governance:* International Corporate Governance Network (ICGN), the Asian Corporate Governance Association (ACGA), the Brazilian Institute of Corporate Governance (IBGC), and the Canadian Coalition for Good Governance (CCGG).
- *Corporate Disclosure*: CDP (formerly Carbon Disclosure Project), Carbon Tracker, the Asset Owners Disclosure Project (AODP), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), Sustainability Accounting Standards Board (SASB) and the Sustainable Stock Exchanges Initiative (SSE).
- *Long-termism:* The Long-term Investing Club, Focusing Capital on the Long-Term (FCLT), and Cambridge Investment Leaders Group (ILG).
- *Responsible Investment:* Network for Sustainable Financial Markets (NFSM), United Nations Environment Programme Finance Initiative (UNEP FI), Australian Council of Superannuation Investors (ACSI), Ceres and the Shareholder Association for Research and Education in Canada (SHARE).
- *Global Sustainable Investment Alliance:* National and regional sustainable and responsible investment forums, such as UK Sustainable Investment and Finance Association (UKSIF), European Sustainable Investment Forum (EuroSIF) and the US Forum for Sustainable and Responsible Investment (USSIF).

References

1) PRI (2015): Engagement guidance on corporate tax responsibility – why and how to engage with your investee companies.
2) PRI (2015): Writing a responsible investment policy: Guidance for asset owners
3) PRI (2013): Aligning expectations: Guidance for asset owners on incorporating ESG factors into manager selection, appointment and monitoring.
4) PRI (2013): Integrated analysis – how investors are addressing environmental, social and governance factors in fundamental equity valuation
5) PRI (2011): Implementation of the PRI by small and resource constrained asset owners.
6) www.unpri.org

6. INTERNAL GOVERNANCE AND ACCOUNTABILITY OF THE INSTITUTIONAL INVESTOR

6.a. To what extent can good internal governance of institutional investors, such as mechanisms aiming to align interests between beneficiaries, board and key executives, influence their ability and willingness to integrate ESG factors in investment decision-making and engage on these issues? Please provide evidence or good practices if possible.

PRI research (1) identifies that institutional alignment is crucial for asset owners, who should:

- Publish investment beliefs, with commitments to take account of ESG issues in investment decision-making and in engagement with companies and issuers.
- Implement investment beliefs throughout the organisation, including Board/Trustees, CEO/CIO, portfolio managers, research analysts and legal counsel.
- Engage public policy makers on issues relevant to sustainable development finance.
- Integrate sustainability factors in the selection process for asset consultants and other advisers.
- Integrate sustainability factors in the selection process for investment managers
- Integrate sustainability factors in the monitoring process for investment managers and investment consultants.

The above actions will ensure that fund managers have clear parameters to act. PRI is currently analysing good governance to support ESG integration, and will release results in 2016.

References

1) PRI (2016): How asset owners can drive responsible investment – beliefs, strategies, mandates

6.b. Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

In 2015, PRI conducted a survey of pension fund beneficiaries (1) which identified that in the UK and France, the majority of beneficiaries do not know which companies they are invested in, and do not feel that their pension provider responds to their concerns.

In our answer to question 1.b, we note that many of the largest European pension markets put some requirement on pension funds to disclose if, and how, ESG issues are factored into investment decision making. We strongly encourage the EU to harmonise and strengthen these requirements via amendment to the revised Institutions for Occupational Retirement Provision (IORP) Directive, which seeks to improve governance and transparency of IORPs.

References

1) PRI (2015): How can pension providers respond to the growing concerns of beneficiaries over ESG considerations? (Presentation)

6.c. Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

The PRI Consumer Survey referred to in question 6.b noted that the majority of those surveyed in the UK and France were concerned about ESG issues such as executive pay, fossil fuels, tax fairness and child labour. However, EU Citizens often have very limited understanding of the financial system (1), and hence how their pensions or savings influence these issues.

References

1) European Parliamentary Research Service (2016): Improving the financial literacy of European consumers

7. THE ROLE OF OTHER SERVICE PROVIDERS

7.a. Is there sufficient long-term oriented, reliable and relevant external investment research? Are there barriers to good quality external investment research on ESG risks and opportunities? If so, please explain. What role, if any, do financial incentives or conflicts of interests of some service providers play?

No PRI Response

7.b. To what extent do investment banks, investments analysts and brokers provide information on medium-to long-term company performance, including corporate governance and corporate sustainability factors, when they make buy, sell and hold recommendations to investors?

No PRI Response

7.c. To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

Advice given by investment consultants is often seen as not supporting proactive approaches to responsible investment. Investment consultants may base their advice on a very narrow interpretation of investment objectives and may omit ESG factors from analysis or recommendations (1).

While the major consulting firms do now have responsible investment specialists or small teams focussed on responsible investment, these are usually established as separate advisory centres rather than being integrated into all investment advisory services, which results in ESG being an additional service and cost.

However, we note that investment consultants say that asset owners rarely raise responsible investment issues with them, which makes them less willing to integrate responsible investment into their mainstream service offerings. PRI recommends that, when appointing investment consultants, asset owners should ask how ESG factors are integrated into the advice that they provide. They should also ensure that ESG issues are standing items in consultant meetings.

References

1) PRI (2016): How asset owners can drive responsible investment – beliefs, strategies, mandates

7.d. To what extent do proxy advisors consider medium-to long term performance of companies, including ESG performance, in their voting recommendations?

Proxy advisors traditionally focus on ensuring good governance, so minimum corporate governance standards are typically embedded into proxy advisors' main regional and overarching voting policies. However, many advisors are less transparent about if (or how) environmental and social factors are taken into account. It is worth noting that over the last few years some proxy advisory firms have started to offer custom ESG or SRI voting policies as an additional service, while a few have clearly integrated specific ESG issues such as diversity into their policies.

Executive remuneration is the most notable area of analysis for which proxy advisors look at company long-term company performance, although there is still significant debate as to whether financial metrics traditionally used by most companies are truly indicative of such. We are aware that proxy firms are starting to look at how executive pay is linked to metrics aligned to ESG factors as drivers of long-term value creation. However, we are not aware of any instances where prominent advisors have recommended voting against an executive remuneration policy on the basis that it does not include ESG criteria.

7.e. To what extent do credit rating agencies take medium-to long term performance of companies, including ESG performance, into account in their ratings?

Issues such as climate risk, poor governance or political instability can influence an issuer's creditworthiness. Many PRI signatories use ESG factors to provide additional, forward looking insight into issuer creditworthiness. ESG incorporation in fixed income is one of the fastest growing areas of practice amongst PRI signatories (1).

Credit rating agency (CRA) opinions typically run to five years. This is a realistic horizon for assessing issuer creditworthiness, but is not aligned with the long-term time horizon of most institutional investors. CRAs do incorporate some ESG factors, particularly governance issues, into their rating approaches. However, this could be done in a more systematic and transparent way, with a stronger understanding of the possible implications of ESG issues. For example, after the Volkswagen environmental and corporate governance scandal, S&P cut VW's short and long-term corporate credit rating and lowered its assessment of VW's management (2). This was a reactive measure - greater insight into governance-related risk might have prompted a pre-emptive response.

A 2015 survey of 99 PRI signatories found that 75% want CRAs to commit to an aspirational goal of incorporating ESG factors and 64% felt that CRAs should demonstrate their understanding of ESG. PRI is currently developing project to bring investors and CRAs together to explore how these risk factors can be incorporated into credit ratings in a systematic and transparent way.

References

1) PRI (2015): Report on Progress
2) Wall Street Journal (October 12, 2015): S&P Downgrades Volkswagen's Credit Rating

7.f. What are the best practices as regards independent external assurance (for example auditor review) for the disclosure by companies of material medium- to long-term risks and opportunities, particularly ESG issues?

PRI encourages the EU to require independent assurance, consistent with audits performed on financial results.

According to a recent CFA Institute ESG survey, 69% of financial analysts agree that it is important that ESG disclosure is subject to independent verification (1). Of this 69%, 44% would like a level of verification similar to an audit (high level of assurance), 49% would like to see limited verification (lower level of assurance).

References

1) CFA Institute (2015): ESG Survey

8. THE ROLE OF NON-PROFESSIONAL INVESTORS

8.a. Do you know of initiatives that led to more sustainable and responsible investment from non-professional investors? Please provide details about them.

No PRI Response

9. LEGAL OR REGULATORY CONSTRAINTS

9.a. Are there legal or regulatory constraints likely to significantly and unduly prevent or discourage investors from taking a long-term view in their investment strategies and decisions and from investing in a sustainable way? If so, please provide details.

The principal barrier is outdated interpretation of investor duties, including fiduciary duty, which we address further in question 9.b.

Regulation such as Solvency II puts in place capital holding requirements, proportional to the level of risk, but do not include ESG factors in the definition of risk. This means that an investment with higher ESG related risk is treated as equivalent to one with low risk, acting as a disincentive to consider ESG factors.

We welcome the EU's recent directive on Non-Financial Reporting, but note that by defining ESG factors as "non-financial", this suggests that they are not financially material. We recommend that the EU consider renaming the Directive to reflect that it is enhancing corporate disclosure around financially material ESG factors.

9.b. Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

As noted in 9.a., a key barrier to mainstreaming of responsible investment is outdated interpretation of investor duties, including fiduciary duty.

Research conducted by PRI and partners (1) found that, when evaluating whether or not an institutional investor has delivered on its fiduciary duties, both the outcomes achieved and the process followed are of critical importance. For example, a decision not to invest in a high-carbon asset because of financial concerns about stranded assets is likely to be seen as consistent with fiduciary duties, providing that the decision is based on credible assumptions and robust processes.

The report found that action is needed to modernise definitions and interpretations of fiduciary duty. To address this, we recommend the following actions to policy-makers:

- Clarify that fiduciary duty requires investors to take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement.
- Strengthen implementation of legislation and codes, clarifying that these refer to ESG issues, and require investor transparency on all aspects of ESG integration, supported by enhanced corporate reporting on ESG issues.
- Clarify the expectations of trustees' competence and skill and support the development of guidance on investor implementation processes, including investment beliefs, long-term mandates, integrated reporting and performance.
- Support efforts to harmonise legislation and policy instruments on responsible investment globally, with an international statement or agreement on the duties that fiduciaries owe to their beneficiaries. This statement should reinforce the core duties of loyalty and prudence, and should stress that investors must pay attention to long-term investment value drivers, including ESG issues, in their investment processes, in their active ownership activities, and in their public policy engagement.

This is consistent with the recent report commissioned by DG Environment on *Resource Efficiency and Fiduciary Duties of Investors* (2).

References

1) PRI, UNEP Finance Initiative, UNEP Inquiry and UN Global Compact (2015): Fiduciary Duty in the 21st Century
2) DG Environment (2015): Resource Efficiency and Fiduciary Duties of Investors

10. OTHERS

10.a. Are you aware of any other incentives or obstacle(s) with a significant impact? If so, which ones?

These issues have been addressed through our response to 1.a.

10.b. Would you consider further increase in sustainable investments if market or regulatory conditions for sustainable investment would be more favourable? If so, please provide estimations, if possible.

No PRI Response