

EU PUBLIC CONSULTATION ON INSTITUTIONAL INVESTORS AND ASSET MANAGERS' DUTIES REGARDING SUSTAINABILITY

INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has 1900 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$70 trillion in assets under management.¹

Responsible investment explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets. The PRI welcomes the opportunity to comment on the EU's public consultation on investors and asset managers' duties regarding sustainability.

2.1 QUESTIONS ADDRESSED TO ALL RESPONDENTS:

I. GENERAL OVERVIEW

1) Do you think relevant investment entities should consider sustainability factors in their investment decision-making?

Yes.

- The incorporation of sustainability factors, or environmental, social and governance (ESG) factors, in investment decision-making improves long-term performance.
- Many countries have introduced regulations, codes or guidance requiring investment entities to take account of ESG issues in their investment decision-making.
- By incorporating ESG factors, investors contribute, rather than undermine, environmentally sustainable, equitable economies.

Financial performance:

It is widely accepted that a focus on ESG factors can significantly enhance risk and return characteristics over a range of time frames. ESG factors enable investors to identify investment opportunities and minimise downside risks, such as the risk of asset stranding.

Selected studies include:

¹See <https://www.unpri.org/signatory-directory/>

- Robert Eccles, Ioannis Ioannou and George Serafeim (2012): “We provide evidence that high sustainability companies significantly outperform their counterparts over the long-term, both in terms of stock market as well as accounting performance.”²
- MSCI (2015): “A significant part of this outperformance was not explained by style factors alone; our research shows that ESG factors were also drivers of return.”³
- Deutsche Asset Management and the University of Hamburg (2015): “Roughly 90% of studies find a nonnegative ESG–CFP [corporate financial performance] relation. More importantly, the large majority of studies reports positive findings. We highlight that the positive ESG impact on CFP appears stable over time.”⁴

Regulations, codes and guidance:

Many of the world’s largest institutional investors have made public commitments to integrate ESG issues in investment decision making, for example, by signing the Principles for Responsible Investment (PRI).⁵ Many policy makers have also acknowledged the financial materiality of ESG factors, for example, by requiring pension funds to disclose their approach to ESG issues.

Indeed, a comprehensive review of the law and investment practice in eight countries (and later extended to a further six countries) concluded that failing to consider ESG factors in investment processes is a failure of fiduciary duty.⁶

However, as discussed later in the PRI’s consultation response, the PRI finds policy and regulatory effectiveness is hampered by weak implementation and weak signals.⁷

Sustainable financial system:

Investment entities are both reliant on a sustainable financial system and contributors to a sustainable financial system. The ability of investors to earn investment returns into the future relies on environmentally sustainable and equitable economic development. It is in the interests of investors and their beneficiaries and clients that investment activities in aggregate are contributing, rather than undermining, environmentally sustainable, equitable economies.

2) What are the sustainability factors that the relevant investment entities should consider? (Please make a choice and indicate the importance of the different factors (1 is not important and 5 is very important)).

- Climate factors (these include climate mitigation factors as well as climate resilience factors) (5)
- Other environmental factors (5)
- Social factors (5)
- Governance factors (5)

² http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf

³ <https://www.msci.com/www/blog-posts/can-esg-add-alpha/0182820893>

⁴ <https://deutscheam.com/en-fr/our-capabilities/esg/research/esg-and-financial-performance-aggregated-evidence-from-more-than-2000-empirical-studies/>

⁵ <https://www.unpri.org/directory/>

⁶ <http://www.fiduciaryduty21.org>

⁷ <https://www.unpri.org/page/responsible-investment-regulation>

- Others

Each of these factors can be extremely important. The PRI also believes investors should consider the sustainability of the financial system as a whole.

The discretion for which ESG factors are considered, and to what extent, needs to be left with the investment decision-maker. This is because materiality is a dynamic concept. ESG factors can be material over a range of timeframes, and depend on the investment strategy, asset class, market, country and company. This 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.

3) Based on which criteria should the relevant investment entities consider sustainability factors in their investment decision making?

The PRI believes that investment entities should consider:

- The financial relevance of ESG factors over a timeframe consistent with the obligation of the pension fund or individual client.
- The investment preferences of beneficiaries.
- The regulatory requirements and trends on ESG issues.
- The stability and resilience of the financial system.

The PRI's investment practice guides describe a range of ways in which investors can consider ESG factors in their investment decision making. For example, the PRI's Practical guide to ESG integration for equity investing sets out four integration techniques: Fundamental (stock selection), quantitative, smart beta and passive / enhanced passive.⁸

The PRI's reporting and assessment framework identifies common ESG factors that investors should consider, although, this list is not intended to be exhaustive. Examples of:

- E factors: climate change, greenhouse gas (GHG) emissions, resource depletion, including water, waste and pollution and deforestation.
- S factors: working conditions, including slavery and child labour, local communities, including indigenous communities, conflict, health and safety and employee relations and diversity.
- G factors: executive pay, bribery and corruption, political lobbying and donations, board diversity and structure and tax strategy

4) Which of the following entities should consider sustainability factors in their investment decision-making? (Possibility to select several answers). If so, please indicate the level of impact that this would have (1 is the smallest impact and 5 is the highest impact).

- Occupational pension providers (5)
- Personal pension providers (5)
- Life insurance providers (5)
- Non-life insurance providers (5)

⁸ https://www.unpri.org/download_report/22600

- Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) (4)
- Individual portfolio managers (4)

For the reasons set out in question 1, the PRI believes that all institutional investors and their service providers should have processes in place to consider ESG factors in their investment decision-making. The importance of each entity depends on market structure, investment practice and policy and regulation.

In particular, the PRI believes that asset owners are uniquely positioned to drive responsible investment. A number of European asset owners have made considerable efforts to integrate ESG factors in their investment processes, however, the PRI finds that depth and scale of implementation can vary.⁹

Weak implementation sends signals to the market as a whole that ESG factors are 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.

II. PROBLEM

5) To your knowledge, what share of investment entities active in the EEA (European Economic Area) currently consider sustainability factors in their investment decisions?

All or almost all / More than two thirds / More than half / More than a third/ None or almost none / No opinion

- Occupational pension providers (None or almost none*)
- Personal pension providers (retail product – no opinion) (None or almost none)
- Life insurance providers (None or almost none)
- Non-life insurance providers (None or almost none)
- Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) (None or almost none)
- Individual portfolio managers (None or almost none)

* The PRI is interpreting “none or almost none” as “less than a third”. This is consistent with the studies set out below.

As mentioned in Question 1, many of the world’s largest institutional investors have made public commitments to integrate ESG issues in investment decision making, however, despite public commitments, many investors do not systematically integrate ESG factors through their investment processes.

- The PRI / CFA institute surveyed 58 investors in 2017. 74% of respondents were European, most were fund managers. Of these:
 - 83% say portfolio managers and analysts do not regularly include material ESG issues in equity analysis
 - 75% say portfolio managers and analysts do not regularly include material ESG issues in credit analysis

⁹ https://www.unpri.org/download_report/6385

- State Street: “While 80% of those surveyed considered ESG to some extent, the depth of ESG exposure within portfolios remains low: only 17% of respondents have more than 50% of assets with exposure to ESG factors, and 44% have less than 25%.”¹⁰
- OECD: The OECD surveyed 77 large pension funds on their ESG / long term investing approaches. Of these 22 of 77 make green investments of some kind, however typically it is in the range of 0.1 – 1.5% of Assets Under Management.¹¹
- Mercer: Mercer surveyed over 1200 European pension funds in 2017. Around 20% of European pension funds surveyed by Mercer integrate ESG factors into investment policy, though this incorporates a range of ESG approaches. Report also notes a sharp increase in the number of funds integrating ESG due to financial materiality of ESG risk. 5% of European pension funds have considered climate risk.¹²
- Swisscanto’s [pension study](#) finds between 98.1% and 92.4% of assets are invested without considering ESG (depending on the size of the pension fund).¹³
- ShareAction conducted an in depth study of 40 European asset managers and found a very wide variation between leaders and laggards on ESG factors. This report also concluded legal clarity around ESG was necessary.¹⁴
- The UK Financial Conduct Authority refers to an Investment Association (UK) study: “In a recent sample of 34 IA members, half reported that they managed at least some proportion of assets according to ESG considerations and, where they did, approximately one fifth of total assets were subject to ESG requirements”.¹⁵
- Aviva Investors: “A recent global survey of 342 financial analysts by [Aviva Investors](#) found that 42% of respondents thought research published by banks and brokers was preoccupied with short-term financial metrics. The survey further found that by neglecting environmental, social and governance issues that give indicators as to the health of a company, financial analysts are failing to provide investors with the information needed to make informed decisions.”¹⁶

6) To your knowledge, which is the level of integration of sustainability factors by the different investment entities (active in the EEA)? (High / Medium / Low / none / no opinion)

- Occupational pension providers (low)
- Personal pension providers (no opinion)
- Life insurance providers (low)
- Non-life insurance providers (low)

¹⁰ <https://www.ssga.com/investment-topics/environmental-social-governance/2017/esg-institutional-investor-survey-uk.pdf>

¹¹ <http://www.oecd.org/daf/fin/private-pensions/2015-Large-Pension-Funds-Survey.pdf>

¹² <https://www.uk.mercer.com/newsroom/european-asset-allocation-report-2017-climate-change-risk.html>

¹³ https://www.swisscanto.com/media/pub/1_vorsorgen/pub-107-pks-2017-ergebnisse-deu.pdf

¹⁴ <https://shareaction.org/wp-content/uploads/2017/03/Survey-LiftingTheLid.pdf>

¹⁵ <https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf>

¹⁶ <https://www.avivainvestors.com/en-gb/media/press-releases/aviva-investors-proposes-reform-of-sell-side-research.html>

- Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) (low)
- Individual portfolio managers (low)

Our general answer is low.

Analysis of PRI reporting data demonstrates that a number of asset owners and investment managers in Europe have made commitments to ESG issues in their responsible investment policies,¹⁷ however, we find that depth and scale of implementation varies. In particular, implementation varies across asset classes, with ESG incorporation reported more frequently in listed equity than other asset classes.

7) Which constraints prevent relevant investment entities from integrating sustainability factors or facilitate their disregard. Please provide the importance of the different constraints that you consider relevant (1 is not important and 5 is very important).

- Lack of expertise and experience (3)
- Lack of data/research (3)
- Lack of impact on asset performance (2)
- Inadequate methodologies for the calculation of sustainability risks (3)
- Inadequate sustainable impact metrics (2)
- Excessive costs for the scale of your company (2)
- No interest from financial intermediaries (4)
- No interest from beneficiaries/clients (4)
- European regulatory barriers (5)
- National regulatory barriers (5)
- Lack of fiscal incentives (2)
- Lack of eligible entities (3)
- Others

Please provide more details on what the constraints/reasons are and how they limit the integration of sustainability factors:

All of these barriers are important and can be reinforcing.

The PRI identifies five distinct barriers to asset owners taking a more proactive approach to considering ESG factors. These are:

- 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 advice given by investment consultants, which is often seen as not supporting proactive approaches to responsible investment.

¹⁷ Of the 521 European Signatories reporting to PRI in 2015, 485 (93%) hold a responsible investment policy

- The products provided by investment managers, which often do not meet the responsible investment needs of asset owners.
- The perception that investor duties, and in particular, fiduciary duty, prevents investors from taking a proactive approach to responsible investment. As noted in our scores above, weaknesses in policy and regulation send signals to investors that sustainability is separate from the core purpose of financial markets.

8) How challenging is it for relevant investment entities to integrate the different sustainability factors?

(1 is not challenging and 5 is very challenging) - Please refer to the definition in the Glossary).

- Climate factors (these include climate mitigation factors as well as climate resilience factors) 3
- Other Environment factors 4
- Social factors 4
- Governance factors 2
- Others

Please explain:

The PRI reporting data suggests that some investors consider integration of governance factors to be most advanced, with social factors being the most challenging. This is due to weaknesses in corporate disclosure and difficulties in quantifying social factors. Weaknesses in corporate ESG disclosures make it difficult for investors to make meaningful comparisons between companies.

Enhancing disclosure could involve supporting efforts to ensure the comparability and consistency of the data being reported, analysing whether and how this reporting is affecting corporate practice and performance and considering whether these data need to be assured in a similar manner to other financial reporting.

However, leading investors have demonstrated that it is possible to incorporate all ESG factors across their investment processes. ESG service provision is demand-led and therefore, the PRI believes that policy and regulatory clarification will improve the reporting and incorporation of climate, environment and social factors in investment processes.

III. POLICY OPTIONS

9) In which area should relevant investment entities consider sustainability factors within their investment decision-making? Please make a choice and indicate the relevance of the different areas (1 is minor relevance and 5 is very high relevance).

- Governance (5)
- Investment strategy (5)
- Asset allocation (5)
- Risk management (5)
- Others (stewardship)

All, including in active ownership and stewardship.

The PRI believes that institutional investors and their service providers should have robust processes in place to consider ESG factors in their investment decision-making. This includes in governance, investment strategy, asset allocation, risk management and stewardship.

10) Within the area of governance, which arrangements would be most appropriate to enable the integration of sustainability factors? (1 is the not appropriate and 5 is the very appropriate).

- Specific sustainability investment Committee (4)
- Specific sustainability member of the Board (2)
- Sustainability performance as part of remuneration criteria (4)
- Integration of sustainability factors in the investment decision process (5)
- Integration of sustainability checks in the control process (4)
- Periodic reporting to senior management/board (4)
- Others

All of the above are appropriate responses, however it's important to note that governance arrangements vary with investor type and with the legal structures employed in each member state (for example, Germany has a very different concept of pension trustees than the UK). The most important is the integration of sustainability factors in the investment decision process.

Others:

- The integration of ESG factors into the statement of investment policy principles or equivalent (investment beliefs) is an important part of the process. The European Supervisory Authorities (ESAs) have already done some work as part of the peer review of the IORP directives. The PRI recommends that SIPP disclosures include the ESG components of IORP ii requirements.

11) Should insurance and pension providers consult their beneficiaries on an annual/periodic basis on their preference as regards sustainability factors?

Yes.

The PRI recommends a duty to pay attention to the broad range of preferences of beneficiaries.

The PRI notes that, in some cases, implementation may be challenging. Resource constrained funds or funds with disengaged beneficiaries may find it challenging to determine their beneficiaries interests and preferences. The PRI believes that it should be acceptable to make some assumptions based on credible data or knowledge about the beneficiaries of the fund.

Importantly, the duty to pay attention to the preferences of beneficiaries is separate from the duty to consider ESG issues that can be material to investment risk and return.

12) Within the portfolio's asset allocation, should relevant investment entities consider sustainability factors even if the consideration of these factors would lead to lower returns to beneficiaries/clients in the medium/short term?

Investors should consider ESG factors on the basis that they can be material to investment risk and return over a range of timeframes and therefore are central to performance of the duty of care. In doing so, investors should ensure that they consider ESG factors over a time horizon that

is consistent with the obligation to the pension fund member or individual client. This is to ensure that the investment approach reflects the interests of the beneficiary or client.

Where there is a positive or neutral investment outcome associated with the consideration of sustainability factors, these should be incorporated into the investment strategy.

Where the investment entity is unable for any investment reason, to reflect the ESG factors and time horizon of the member or client in the investment strategy, after having assessed those interests and timeframe, the ESG factors should be considered in terms of member or client preferences.

Investors should (also) seek to understand the sustainability preferences of pension fund members and individual investment clients to ensure that these factors are considered in the investment strategy.

If the investment entity is unable to reflect the sustainability preferences of members or clients with a positive or neutral investment outcome, they should clearly disclose to those members or beneficiaries the investment implications of including their preferences and ensure that the member or client can provide their consent on the investment strategy undertaken on their behalf. If the investment entity chooses not to reflect those preferences, this should also be disclosed, including the rationale for the approach taken.

13) Within the area of risk management, does the current set of corporate disclosures provide the relevant investment entities with adequate information to perform sustainability risk assessments in respect of investee companies?

Please explain where the possible gaps are, if any:

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".

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

- Lack of timely data: Companies should treat material ESG information as market sensitive and disclose it in a timely manner.
- Limited 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.
- Lack of quality: The company should provide details of steps taken to ensure the fairness, balance and veracity of the information reported.
- Lack of 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.

The PRI has endorsed the TCFD recommendations and incorporated within PRI's reporting and assessment framework. We have also encouraged investors and governments to endorse the recommendations.¹⁸

14) Do the overall information or risk metrics available enable the relevant investment entities to adequately perform sustainability risk assessments?

Yes.

ESG disclosure gaps should not be a reason to fail to carry out sustainability risk assessments. The PRI believes investors should use stewardship and active ownership to close ESG disclosure gaps where they exist.

15) Do you think that uniform criteria to perform sustainability risk assessments should be developed at EU level?

No.

Per question 2, the discretion for which ESG factors, and to what extent, needs to be left with the investment decision-maker.

16) In case material exposure to sustainability factors is identified, what are the most appropriate actions to be performed by the relevant investment entity?

There are a variety of strategies which can be deployed individually or in combination, depending on the circumstances. For example, there may be a response at asset allocation level, individual portfolio level, at individual asset level (e.g. stock or bond) and at system level (e.g. public policy engagement).

At the individual asset level, investors can buy, hold or sell. Passive and active investors can also engage through active ownership and stewardship. The PRI provides a number of guides and case studies to demonstrate how investors can respond to material ESG factors.¹⁹

17) Should relevant investment entities disclose how they consider sustainability factors within their investment decision-making?

If yes, what areas should the disclosure cover? Please make a choice and indicate the relevance of disclosure within the different areas (1 is minor relevance and 5 is high relevance):

- Governance (5)
- Investment strategy (5)
- Asset allocation (5)
- Risk management (5)
- Other

¹⁸ http://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2017?docId=workspace%3A%2F%2FSpacesStore%2F6772b882-9e69-44d8-b9a4-1028b6ed876a&xtor=RSS-1

¹⁹ <https://www.unpri.org/about/pri-teams/investment-practices>

If yes, where?

- Pre-contractual disclosure (e.g. prospectuses) (Yes)
- Semi-annual/annual reports (Yes)
- Periodic reports (Yes)
- Website (Yes)
- Newsletters (Yes)
- Factsheets (Yes)
- Marketing materials (Yes)
- Others

Investor ESG disclosure can be to the regulator, the client or to the general public. There is scope for improvement in all three.

As ESG issues are financially material, some disclosures are not appropriate to be made public as they may breach commercial confidentiality. This has been recognised in the provisions of the non-financial reporting directive and taken up by most Member States in their implementation measures.

Some EU Directives already address sustainability disclosures. The IORP ii Directive requires ESG issues to be integrated into risk assessments and to be presented to the regulator as well as ESG issues to be integrated into investment strategy and to be presented to the general public.

IV. IMPACTS FOR STAKEHOLDERS

18) Which stakeholder groups would incur costs and which would benefit from integrating sustainability factors within investment decision-making by relevant investment entities?

- Occupational pension providers (Yes, but should be understood in the context of other benefits)
- Personal pension providers (Yes, but should be understood in the context of other benefits)
- Life insurance providers (Yes, but should be understood in the context of other benefits)
- Non-life insurance providers (Yes, but should be understood in the context of other benefits)
- Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) (Yes, but should be understood in the context of other benefits)
- Individual portfolio managers (Yes, but can be incorporated into existing processes)
- General public (Yes, but can be considered non-material)
- Retail investors (Yes, but can be incorporated into existing processes)
- Financial advisors (ESG advice is a potential revenue growth)
- Service providers (index provider, research providers...) (ESG index providers is a potential revenue growth)
- Other stakeholders (please specify)

All institutional investors who incorporate ESG factors may incur costs related to research, education and training or recruitment of appropriately skilled investment staff and potentially index fees. These costs are non-material relative to usual costs associated with institutional investment.

The PRI recommends that institutional investors ensure that their approach to the incorporation of ESG factors is consistent and complementary to their wider investment and organisational objectives. In particular, investors can use existing investment processes to deliver and implement their ESG commitments. ESG issues should be seen as just another set of issues to be considered in investment research and decision-making.

Indeed, investment strategies and beliefs that incorporate ESG issues can help investors to better understand the investment risks taken by the investment entity and by its service providers, which can contribute to improved decision-making on selecting and retaining managers. Some active investment management services that focus on sustainability investing have higher fees associated with them, however, institutional investors should understand ESG-related costs in the context of the investment and other benefits that are likely to accrue.

Recently, factor investing has opened up the possibility of seeing ESG issues as a factor to be incorporated on a quantitative basis into low-cost index portfolios. This is discussed in PRI's *Investment consultant services review*.²⁰

2.2 Questions addressed to end investors

These questions are for investors only.

2.3 Question specifically addressed to relevant investment entities

These questions are for investors only.

²⁰ <https://www.unpri.org/about/pri-teams/sustainable-financial-system/investment-consultant-services-review>