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POTENTIAL POLICY MEASURES TO SUPPORT A STRONG AND GROWING ECONOMY: POSITIONING CANADA'S FINANCIAL SECTOR FOR THE FUTURE

About the PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI represents 1800 investor signatories globally with $70 trillion in assets under management, 99 of which are Canadian.[1]

Responsible investment is an approach to investment that explicitly acknowledges the financial relevance to the investor of environmental, social and governance (ESG) factors, and the long-term health and stability of the market as a whole.

SUMMARY OF RESPONSE

The PRI welcomes the Department of Finance Canada consultation, which includes issues important to our signatories, such as climate change.

[1] In January 2017, we published our roadmap on fiduciary duties in Canada. It followed interviews with over 30 stakeholders at different points in the Canadian capital markets and informs our response. In June, we published a Climate Disclosure Regulation Review of Canada with Baker McKenzie. This report assesses the local relevance of the recommendations made by the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD).

Both projects are part of PRI's sustainable financial system programme which looks to address the obstacles to financial system sustainability that lie within market practices, structures and regulation. See www.unpri.org/sfs.

The consultation is taking place against a backdrop of regulatory interest in responsible investment – notably, the UK government's Green Finance Taskforce, the Ontario Pension Benefits Act regulation 909, Europe's occupational pension fund ESG disclosure requirements and the High Level Expert Group (HLEG) in sustainable finance.[2]

Institutional investors have a responsibility to the long-term interests of their clients; such interests are often multi-year or even multi-decade. Numerous academic and market studies find fund out-performance through ESG incorporation, particularly over long-term time horizons.[3] It is the PRI's view that failing to incorporate ESG issues is a failure of fiduciary duty.

However, despite significant progress, many institutional investors have yet to fully incorporate ESG issues into investment analysis and decision-making processes.

The PRI recommends that the Department pay more attention to the incorporation of ESG issues – in corporate and institutional investor disclosure, in stewardship and active ownership, in investment advice, and in investment processes and decision-making.

The PRI also recommends the Department goes beyond ESG integration to consider how the financial system works in aggregate in delivering sustainability outcomes. The PRI has a programme set up to deliver a sustainable financial system, which includes working with global finance departments.

The PRI believes incorporating sustainability within the financial sector framework will strengthen financial system stability and contribute toward objectives in energy transition, infrastructure financing and other priorities of the federal government.

To support this, **the PRI recommends the Department set up its own expert group on sustainable finance in the Canadian context**.

This response also provides recommendations to the specific questions addressed in the consultation, on: corporate governance, specifically gender diversity, cyber-risk and director elections and climate-risk.

SPECIFIC FEEDBACK

INTERNATIONAL EFFORTS TO ALIGN SUSTAINABILITY AND FINANCIAL POLICY

[2] The PRI maintains a mapping of responsible investment regulation on its website: https://www.unpri.org/about/pri-teams/policy/responsible-investment-regulation

[3] For example:

1. https://www.bofaml.com/en-us/content/esg-socially-responsible-investing-strategies.html
2. https://www.ft.com/content/7fa69ed0-6d69-11e7-b9c7-15af748b60d0

The idea that financial policy and regulation should support sustainability outcomes is gaining momentum around the world. These initiatives have been led by governments or regulators and seek the active participation of investors to help shape policy frameworks, typically through establishing working groups.

We recommend the Department convene its own initiative to advise on policy and regulatory reform in Canada.

High Level Expert Group on Sustainable Finance

The European Commission decided to establish a High-Level Expert Group (HLEG) on sustainable finance in September 2016. The objective is to provide a roadmap towards a sustainable financial system that fosters sustainability in economic, social and environmental developments.[4]

The HLEG has been given the task of setting out the scale of the challenges and opportunities of sustainable finance, as well as recommending a comprehensive programme of reforms to the EU policy framework.

Specifically, the HLEG is charged with delivering policy recommendations that aim to:

- Provide a vision for sustainable finance;
- Integrate sustainability into the EU's regulatory and financial policy framework;
- Mobilise capital for a sustainable economy.

The group was formed by bringing together experts with diverse profiles and expertise representing different approaches to this broad and complex topic.

UK Green Finance Taskforce

The UK Government established a taskforce in September 2017 of senior financial experts to accelerate growth of green finance and the UK's low carbon economy. The Taskforce will be given six months to deliver ambitious proposals to accelerate investment in the transition to a low carbon economy, creating high-value jobs and opportunities for UK businesses. It will examine a range of interventions, from making infrastructure investment more sustainable to scaling-up green mortgages

German Hub for Sustainable Finance

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[4] The HLEG defines a sustainable financial system as one that:

- Considers the full value of financial assets, incorporating sustainability factors into valuation and product design;
- Is productive, serving its users in their projects and needs, notably households, firms and governments;
- Is resilient, withstanding and recovering from a wide range of both external and internally generated shocks;
- Demonstrates alignment between the sustainability preferences of its users and the outcomes of the decision-making process, ensuring accountability and transparency;
- Takes a long-term perspective and overcomes the 'tragedy of the horizon'.

The Hub for Sustainable Finance (HS4F) has been formed by Deka Investment, Deutsche Börse AG, the German Council for Sustainable Development (RNE), PRI and the Hessian Ministry of Economics, Energy, Transport and Regional Development to coordinate activities to promote development of the sustainable finance sector. The HS4F is supported by the Federal Finance Ministry and will review regulatory issues, determine criteria and develop market incentives and instruments to support the development of sustainable finance.

PROMOTING DIVERSITY ON BOARDS

We support comply-or-explain disclosure requirements for the participation of women on boards and in senior management across listed companies.

Female representation on boards and in senior management has been shown to correlate to better returns on equity, net profit margins, and earnings per share[5], along with lower volatility.[6] Furthermore, research suggests the benefits of gender diverse companies may include greater employee productivity, innovation, talent recruitment and retention, as well as customer acquisition and retention.[7]

Gender diversity in leadership is a priority issue for investors in Canada. In September 2017, the 30% Club Canadian Investor Group published a statement of intent calling on companies to achieve 30% women on boards and at the executive level of S&P/TSX composite index by 2022.

STRENGTHENING SHAREHOLDER DEMOCRACY IN THE ELECTION OF DIRECTORS

We support the proposal for annual elections with fixed one year terms for all regulated financial institutions.

We recommend a majority vote standard in line with TSX listing requirements. Where a majority vote standard is used for federal financial institutions, we similarly recommend that companies disclose how the standard will be implemented and that companies consider shareholder views in board composition.

We also recommend the Department mandate individual director elections for all federally-regulated financial institutions. In particular, investors should have informed insight into the ESG skills and qualifications that each candidate contributes to the board.

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[5] Value for Women. The bottom line: Why Gender Inclusion is Good for Business.
[6] Morgan Stanley. An Investor's Guide to Gender Diversity.
[7] Morgan Stanley. Why it pays to invest in gender diversity.

CYBER-RISK

Cyber security has been identified as a priority issue across our signatories, as a costly, global and cross-sector risk in investment portfolios. We recommend greater transparency around companies' risk mitigation, budgeting, training and recovery action plans.

CLIMATE RISK DISCLOSURE

We are pleased to see that the Department is following the Canadian Securities Administrators (CSA) review of climate disclosures in Canada following the launch of the Financial Stability Board's industry-led Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

Climate change is increasingly material to the financial sector. Mark Carney, the Governor of the Bank of England[8] has identified three types of climate related risks:

- Physical: risks that could arise from extreme weather events such as flooding and storms which could damage property, national infrastructure and disrupt trade;
- Transition: risks that could arise from the process of adjusting to a lower-carbon economy, such as changes in policy, technology, or investor sentiment;
- Liability: risks that could arise from parties who have suffered loss or damage. The interconnected nature of the global financial system could expose Canadian financial institutions to claims that occur in third countries.

Securities regulators have a clear interest in ensuring the financial system is resilient to any economic transition. An efficient market reaction to climate risks requires transparency. It will help smooth price adjustments as information changes, rather than concentrating them in a single climate "Minsky moment".[9]

In August 2017, the PRI responded to the CSA review, recommending for the CSA to:

- Publicly endorse the TCFD's recommendations; this includes recommendations for static disclosure and also forward looking scenario analysis that would stress test the performance of portfolios in a carbon constrained world;
- Issue guidance on implementation of the TCFD's recommendations, and monitor progress;
- Undertake similar consultations to account for all material ESG factors.

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[8] Source the Bank of England webpage on "Climate change, green finance and financial stability"
[9] When a market fails falls into crises after a sustained period of market speculation or unsustainable growth.

We also encourage the Department to continue to contribute to the green finance work in the G7 and G20.

If you would like to receive more information about our work, we can discuss at your convenience via:

- PRI's Head of Canada: Nalini Feuilloley – nalini.feuilloley@unpri.org
- PRI's Head of Policy: Will Martindale – will.martindale@unpri.org.

Yours sincerely,

Fiona Reynolds

Managing Director

Principles for Responsible Investment