PRI AND UNEP FI'S RESPONSE TO IOPS SUPERVISORY GUIDELINES ON THE INTEGRATION OF ESG FACTORS IN THE INVESTMENT AND RISK MANAGEMENT OF PENSION FUNDS

INTRODUCTION

The United Nations-backed Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2000 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $82 trillion in assets under management. 1489 signatories of PRI's signatories, of which 291 asset owners, are headquartered in IOPS member countries.

The United Nations (UN) has been supporting the Principles for Responsible Investment ever since their launch. The PRI has two UN partners – UN Environment Programme Finance Initiative (UNEP FI) and UN Global Compact – which play an important role in delivering the PRI's strategy. UNEP FI is a unique global partnership between UN Environment and the global financial sector founded in 1992. UNEP FI works closely with over 230 financial institutions who have signed the UNEP FI Statements as well as a range of partner organisations to develop and promote linkages between sustainability and financial performance. 171 of UNEP FI signatories are based in IOPS member countries.

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 and UNEP FI welcome the opportunity to contribute evidence to the draft *Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk management of Pension Funds* prepared by IOPS.

ABOUT THE CONSULTATION

The draft *Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds* prepared by IOPS (the draft guidelines) are formulated to promote ESG integration amongst pension fund regulators. The draft guidelines articulate how pension fund supervisory authorities should articulate the way ESG factors should be considered and integrated in the supervision of investment and risk management of pension funds .

The current public consultation has been launched to explore views on the draft guidelines by industry participants and international organisations.

PRI AND UNEP FI'S RESPONSE TO THE GUIDELINES

The PRI and UNEP FI welcome the draft *Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds* prepared by IOPS.

The draft guidelines will support pension fund supervisory authorities to promote the development of responsible investment practices and enhance sustainable long-term financial performance.

In particular, we welcome:

- The requirement that pension fund governing bodies should consider ESG factors in pension funds investment and risk management process (article 1.1);
- That supervisory bodies should clarify that the explicit integration of ESG factors into pension fund investment and risk management process is in line with fiduciary duties (article 1.2);
- That asset managers involved in the development and implementation of a pension fund investment policy should integrate ESG factors in investment strategies and report how they do so (articles 1.5, 1.7, 1.8 and 1.9);

We recommend that IOPS:

- Clarifies in the guidelines that **investors should integrate all value drivers, including ESG factors, in investment decision making**, to better manage risks and generate sustainable returns. The current language could be misleading as it sets in some parts of the guidelines ESG factors as independent to core investment activities.
- Proposes that pension fund supervisors introduce regulations on ESG disclosure by pension funds and their asset managers. Our international experience shows that **investment guidelines and codes that are embedded in the legal framework are more impactful than those that are voluntary**[1]. IOPS should support its members to introduce the most critical parts of the *draft guidelines* into regulatory acts, for example on pension fund and their asset managers' disclosure on ESG integration in investment and risk management processes.
- Notes that **ESG factors may also affect performance in the short term**, and not only in the long-term, and as such, ESG integration is a duty for risk management and generating sustainable returns.
- Clarifies that **ESG integration in traditional financial analysis is driven by financial rather than ethical implications.** Rather than referring to 'risks of ESG investments', the guidelines should encourage supervisory authorities to make clear that the integration of ESG factors into decision-making by pension governing bodies is a requirement of their fiduciary duties. ESG factors may be material for any investment and should be integrated in decision-making regardless of whether the investment strategy has an ESG focus or not.
- Specifies that pension funds should integrate ESG factors consistent with the **investment time-frames of their clients and beneficiaries**, and, in addition, **integrate beneficiaries' ESG preferences**.
- Proposes that pension funds, or their investment managers on their behalf, **adopt active ownership practices and incorporate ESG factors into their ownership policies and practices**.

The draft guidelines are consistent with a global trend on sustainable investment regulations. For example:

- The European Commission Action Plan for Financing Sustainable Growth aims to further promote sustainable and green investment through regulatory measures, such as a taxonomy on sustainable investment, clarification on institutional investors and asset managers' duties to take sustainability into account in the investment process, low-carbon benchmarks and better advice to clients on sustainability[2]. In June 2018, the EU published a proposal for a regulation on disclosures relating to sustainable investment and sustainability risks. This regulation will introduce obligations on institutional investors and asset managers to disclose how they integrate ESG factors in their risk processes. Political agreement on this proposal was reached in March 2019.
- In the UK, the government published an update to the Investment Regulations in September 2018, setting out requirements for trustees to include in their statements of investment principles how they take account of ESG considerations, policies on stewardship and voting, set out how ESG is integrated in the default fund, prepare a statement on members views (including on ESG factors), and how they would be taken into account.[3]

The proposals in the draft guidelines are consistent with the recommendations of the recent PRI and UNEP FI work on Fiduciary Duty in the 21st Century programme, including the report on *Aligning Investors with Sustainable Finance – A Focus on the OECD*, published with The Generation Foundation in December 2018. This report specifically supported IOPS work on promoting dialogue on ESG integration amongst pension fund regulators and establishing guidelines on ESG factors and setting standards in terms of ESG integration in the supervision of pension fund investment and risk management, by seeking alignment with the highest standards among OECD / IOPS countries. The draft guidelines of IOPS are an important step forward in this direction.

Additional comments, including on background note and articles annotations, are presented below.

DETAILED RECOMMENDATIONS ON THE GUIDELINES

Background note, paragraph 2:

ESG integration is not only driven by fund members, investment managers or policy makers' expectations, but also by the inherent role ESG factors may play in corporate performance. We recommend adding this wording after the second sentence:

'In addition, ESG integration is driven not only by fund members, investment managers or policy makers' expectations, but also by the link between corporate performance and ESG risks and opportunities, and is required where ESG factors are financially material'.

See as evidence the CFA Institute / PRI reports on ESG integration[4].

Background note, paragraph 6:

We recommend adding the example of the UK mentioned previously:

'In the UK, the government published an update to the Investment Regulations in September 2018, setting out requirements for trustees to set out in their statements of investment principles how they take account of ESG considerations, policies on stewardship and voting[5], set out how ESG is integrated in the default fund, prepare a statement on members views (including on ESG risks and opportunities), and how they would be taken into account.'[6]

Background note, paragraph 7:

While an adaptation period for less advanced markets through voluntary guidelines is sometimes necessary, we recommend that IOPS sets standards in terms of ESG integration in the supervision of pension fund investment and risk management, by seeking alignment with the highest standards among OECD countries.

We recommend adding a last sentence to this paragraph stating:

'Regulators and policy makers must establish high standards in terms of ESG integration by pension funds, aligning with the goals of the Paris agreement and the Sustainable Development Goals.'

Background note, paragraph 8:

The language used in the last sentence of this paragraph may be misleading:

'*these Guidelines do not intend to induce pension funds into ESG investments but to require them to consider in their investment and risk management process ESG factors that may have financial consequences.*'

We recommend writing instead:

'these guidelines do not intend to induce pension fund to make specific investment decisions, but to require them to consider in their investment and risk management process material ESG factors that may have financial consequences'.

Background note, paragraph 9:

As mentioned in the comment to paragraph 7, we recommend that IOPS promotes the highest standards and best practices across its member constituencies. We propose adding at the end of this paragraph the following sentence:

'While an adaptation period might be needed in some markets, pension fund regulators must align long-term investment and risk management regulations with the goals of the Paris Agreement and the SDGs.'

Definitions, paragraph 11:

The sentence '*most ESG risks and opportunities have a long-term nature'* may be misleading. Evidence shows that many environmental, social and governance factors may have a short-term effect on share price and performance. We suggest replacing '*most'* with '*some'.* We also propose adding the following sentences at the end of this paragraph:

'Some ESG risks have a short-term effect on share prices and performance. Therefore ESG risks and opportunities should be integrated in traditional investment analysis as with any other potentially material risk or opportunity'.

Definitions, paragraph 13:

We recommend replacing the wording 'financial vs non-financial factors' with 'financially material vs non-material factors'.

Material ESG factors have been an essential part of long-term fundamental investment analysis, therefore it is important to draw attention to those ESG factors that are be a source of enhanced operational performance, better risk management and improved financial prospects in investee companies.

The relevance and materiality of ESG factors depend on the asset, time series and investment decisions. We understand ESG risks to be those ESG considerations that are influencing, or are likely to influence, the risk and return characteristics of an investment. ESG risks and opportunities are dynamic, evolving in response to changing scientific understanding and societal expectations. Financial materiality evolves over time, and issues of long-term nature which are not financially material in the short term may also become financial risks or opportunities with evolving regulations and market context.

Definitions, paragraph 14:

In alignment with our comment on paragraph 13 above, we recommend consistency on the terminology and the qualification of ESG factors throughout the document.

Therefore, as noted above, we recommend specifying that some ESG factors may be material while others aren't, and replacing the wording of 'financial vs non-financial factors' with 'financially material vs non-material factors'.

We also suggest adding to this article a requirement to consider materiality of all factors over a time horizon consistent with the liability profile of the scheme and its obligations to members and beneficiaries.

Guidelines, article 1.1:

We recommend replacing '*such wider considerations'* with '*all material value drivers, including ESG factors'*.

We also suggest adding to article 1.1 a requirement to consider materiality of all factors over a time horizon consistent with the liability profile of the scheme and its obligations to members and beneficiaries.

Guidelines, article 1.2:

We recommend adding '*and is required by those fiduciary duties where ESG factors are financially material'*.

Guidelines, article 1.3:

We recommend using the wording 'financially material' and 'non-material' instead of 'financial' and 'non-financial'.

We also recommend adding that pension funds should ensure that they understand the range of ESG preferences of their members and beneficiaries, and reflect those in the investment options that are made available to them.

We also propose adding at the end of the first sentence '*though it is not necessarily the case'.*

Guidelines, article 1.4:

The formulation of this article is confusing. We recommend clarifying the wording as follows:

'Supervisory authorities should require that when offering investment arrangements, the pension fund's investment policy should incorporate ESG factors in order to better manage investment risks and opportunities consistent with the time-frame of the obligation and the liability profile of the scheme'

Annotation, paragraph 19:

We recommend replacing '*prudent investor'* with '*investor'* in the penultimate sentence.

We believe the last sentence of this paragraph may be misleading:

'When considering ESG strategies, governing bodies of pension funds should also take into account costs related to implementation of such investment strategies.'

Formulated this way, ESG integration appears to be a cost while it is meant to improve risk and return as a core part of investment activity. The costs of upgrading investment analysis to include ESG assessment expertise should not be confused with the added value of integrating all material value drivers in investment and risk management. On the cost side, financial data providers such as MSCI, FTSE Russell and Bloomberg, as well as sell-side research firms and proxy advisory services, are providing high-quality ESG data at scale. As industry knowledge and expertise has grown, so too has the number of investors with the skills and tools necessary to extract investment insights and value from third-party ESG data and analytics. A common first step for clients in the ESG research due diligence process is to ask their advisors, consultants and asset managers to explain how they consider ESG factors. Asset managers have been motivated by their clients to improve their ESG research and reporting capabilities including through building internal expertise and sourcing ESG data.

We therefore suggest modifying this sentence to reflect the above analysis.

Annotation, paragraph 20:

The specific use in this paragraph of the wording 'ESG investing' and 'ESG strategies' may be misleading.

In general, we recommend distinguishing between 'ESG integration' which is the process of integrating ESG factors in traditional financial analysis, from ESG strategies, or what is referred to as 'ESG investing', which may refers to different practices. Each asset manager has specific methodologies and uses different combinations of metrics to inform investment analysis, but the *process* of ESG integration qualifies all these different methodologies.

The last sentence of this paragraph:

'*Despite the potential opportunities, the risks of ESG investments also have to be adequately considered.*'

should be deleted.

All investment and risk management activities should consider all material value drivers, including ESG factors, which refers to the need to have a *process* on ESG integration in investment decision-making. However, it may be noted that some *specific*, ESG-themed funds may present particular risks, as any thematic fund. This does not alter the need to integrate, fundamentally, all material ESG factors that may affect investment performance, in investment decision-making.

Annotation, paragraph 21:

We suggest replacing '*financial'* with '*financially material*'.

Guidelines, article 1.5:

While a comply or explain approach may be temporarily used in markets with low awareness on ESG integration, the urgency of the Paris Agreement challenges and of the SDGs require that all pension funds update their investment processes to systematically and explicitly integrate material ESG factors.

For simplification and clarity purposes, we suggest keeping only the first sentence of this article, and replacing '*financial'* with '*financially material'*:

'*Supervisory authorities should require that a governing body and the asset managers involved in the development and implementation of a pension funds' investment policy integrate ESG factors, along with all substantial financially material factors, into their investment strategies (analysis and decision-making process).'*

and deleting what follows.

Guidelines, article 1.6:

We recommend changing the wording to

'Supervisory authorities are encouraged to issue regulations, rules or guidelines […].'.

Annotation, paragraph 24:

In alignment with the wording of article 1.6, change '*may wish*' to '*are encouraged to'*.

Also, suggest adding to the third sentence from the end, '*over a time horizon appropriate to the scheme's liabilities and obligations to members and beneficiaries.*

The last two sentences of this paragraph may be relevant to pursuing ESG-specific strategies, but do not alter the need to integrate consideration of ESG factors as a matter of course.

Guidelines, article 1.9:

We recommend adding at the end of the last sentence, '*processes and performance'*. In order to report in a comprehensive manner, companies need to report on their ESG-related *policies, processes and performance*.

We also recommend adding to this list '*the pension fund's policy for engaging with its members and beneficiaries regarding their ESG preferences'.*

The PRI and UNEP FI have experience of public policy on ESG integration and responsible investment across multiple markets and are available to further support the work of the IOPS on promoting sustainable investment.

Any question or comments can be sent to policy@unpri.org.

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1 See for more details on policy design the PRI Global Guide to Responsible Investment Regulation: https://www.unpri.org/policy-and-regulation/global-guide-to-responsible-investment-regulation/207.article

2 https://www.unpri.org/sustainable-financial-system/explaining-the-eu-action-plan-for-financing-sustainable-growth/3000.article

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf

4 https://www.unpri.org/news-and-press/risk-and-client-demand-are-driving-esg-integration-new-reports-by-the-pri-and-cfa-institute/3621.article

5 See the consultation on the UK FRC Stewardship code: https://www.frc.org.uk/investors/uk-stewardship-code

6 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf