

FIDUCIARY DUTY IN THE 21ST CENTURY

IRELAND ROADMAP

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The views expressed in this report are those of the report authors and do not necessarily represent those of the individuals or the organisations that contributed to the report.

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This roadmap has been developed by the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation, in collaboration with SIF Ireland, Ireland's Sustainable and Responsible Investment Forum. These organisations will continue to work closely together to advance responsible investment practice in Ireland.



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WHAT IS RESPONSIBLE INVESTMENT?

The PRI defines responsible investment as an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.

We note that responsible investment is not the same as ethical investment, socially responsible investment or impact investing. While these approaches seek to combine financial return with moral or ethical considerations, responsible investment can and should be pursued even by the investor whose sole purpose is financial return, because it argues that to ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries.

Why invest responsibly?

The global momentum around responsible investment is driven by:

- Recognition in the financial community that ESG factors play a material role in determining risk and return;
- Understanding that incorporating ESG factors is part of investors' fiduciary duty to their clients and beneficiaries;
- Concern about the impact of short-termism on company performance, investment returns, and market behaviour;
- Legal requirements protecting the long-term interest of beneficiaries and the wider financial system;
- Pressure from competitors seeking to differentiate themselves by offering responsible investment services as a competitive advantage;
- Beneficiaries becoming increasingly active and demanding transparency about where and how their money is being invested; and
- Value-destroying reputational risk from issues such as climate change, pollution, working conditions, employee diversity, corruption, and aggressive tax strategies, in a world of globalisation and social media.

THE GLOBAL PROJECT: AN OVERVIEW

Fiduciary Duty in the 21st Century

In 2015, the PRI, UNEP FI, the UNEP Inquiry into the Design of a Sustainable Financial System and the UN Global Compact launched the Fiduciary Duty in the 21st Century report¹.

Investors often point to their fiduciary duty and the need to deliver financial returns to their beneficiaries as reasons why they cannot do more on responsible investment. In response, the report set out to demonstrate that this assumption is not justified and that, in fact, there is a need to reframe or redefine fiduciary duty in a way that is relevant for 21st century investors. It concluded that:

“Failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty”.

Behind this conclusion is a recognition that the world has changed, with ESG issues as diverse as climate change regulation, labour rights, tax, bribery and corruption, demographic change and consumer expectations affecting investment value and investment performance. This recognition is increasing the focus of investors, investment analysts, companies and regulators on these issues.

In addition, the lawyers interviewed for the 2015 report agreed that, legally speaking, fiduciary duty is a process test. The view was that, when evaluating if an institution has delivered on its fiduciary duties, courts will distinguish between the decision-making process and the resulting decision.

What is fiduciary duty?

Fiduciary duties exist to ensure that those who manage other people's money act in the interest of beneficiaries rather than serving their own interests. The most important of these duties are:

- **Loyalty:** Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party; and
- **Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an “ordinary prudent person” would do.

This last point was interpreted as suggesting that investors may take account of wider ESG issues, so long as there is a clear focus on beneficiaries' interests. For example, a decision not to invest in coal mines (e.g. because of concerns about these assets being stranded as a result of climate change regulations) is likely to be seen as consistent with fiduciary duties so long as the decision is based on credible assumptions and a robust decision-making process.

¹ Sullivan, R., Martindale, W., Feller, E. & Bordon (2015), [Fiduciary Duty in the 21st Century](#), pages 16 and 18

The concept of fiduciary duty is organic, not static. It will continue to evolve as society changes, not least in response to the urgent need for us to move towards an environmentally, economically and socially sustainable financial system.

Paul Watchman, Honorary Professor, School of Law, University of Glasgow

The report found that fiduciary duty has played, and continues to play, a critical role in ensuring that fiduciaries are loyal to their beneficiaries and carry out their duties in a prudent manner. However, it concluded that action is needed to modernise definitions and interpretations of fiduciary duty in a way that ensures these duties are relevant to 21st century investors.

The report set out general recommendations for institutional investors, financial intermediaries, policy makers and regulators in order to embed ESG integration into investment policy and market practice. It then specifically analysed investment practice and fiduciary duty in eight countries – Australia, Brazil, Canada, Germany, Japan, South Africa, the UK and the US – and made specific recommendations for each.

As a collective pension fund, ERAFP is in the business of paying pensions. We will have to invest in assets that will provide performance benefits for 60-70 years. If you consider that very simple objective, it means that you should better consider what makes that asset resilient, what makes that asset sustainable. Taking that into account, understanding your fiduciary duty becomes simple.

Philippe Desfosses, ERAFP (French public service additional pension scheme)

The roadmap project

In January 2016, the PRI, UNEP FI and The Generation Foundation launched a three-year Fiduciary Duty in the 21st Century Project to implement the 2015 report's recommendations². The project has developed and published an international statement on investors' obligations and duties³, developed detailed country roadmaps for each of the eight countries in the original 2015 report, and has analysed fiduciary duty and investment practice in six Asian markets, including China⁴. Other country and state roadmaps are in the pipeline.

² See www.fiduciaryduty21.org

³ See www.fiduciaryduty21.org/investor-statement.html

⁴ Sullivan, R., Feller, E., Martindale, W. & Robinson, J. (2016), [Investor Duties and Obligations in 6 Asian Markets](#).

About SIF Ireland

SIF Ireland, which is Ireland's Sustainable and Responsible Investment Forum, is a membership organisation for those in the financial sector committed to growing responsible investment in the country. SIF Ireland does this because its founders believe that responsible investment practices can provide superior risk-adjusted returns and positive sustainable impact. This is in line with Irish government policy with regard to raising awareness of responsible investment nationally, as outlined under the government's strategy for the international financial services sector, IFS2020. Its members include leaders in responsible investment across the investment chain. SIF Ireland is modelled on similar organisations across Europe and the world. Its goals are to:

- Grow the market by increasing understanding, acceptance and demand;
- Act as a voice for the agenda in Ireland to inform and influence stakeholders;
- Provide networking and member support to maximise our collective strength; and
- Collaborate with other organisations both at home and abroad.

The founding members of SIF Ireland are Sustainable Nation Ireland, Irish Life, the Ireland Strategic Investment Fund, Mediolanum, BCP Asset Management, KBI Global Investors, Amundi, KPMG, L&P Cantor Fitzgerald and the Irish Association of Pension Funds. The Department of Finance is an observer. Since its foundation in 2017, Mercer, MSCI, IForUT and Sustainalytics have joined the forum.

THE CONTEXT FOR THE REPORT

This report was researched and written from January to June 2018. Its backdrop and context include the fact that Irish legislation and common law interpretations of fiduciary duty currently make no reference to ESG issues or to responsible investment. While asset owners are not explicitly prohibited from focusing on ESG issues, there are no legislative requirements to pay attention to these issues in their investment practices and processes.

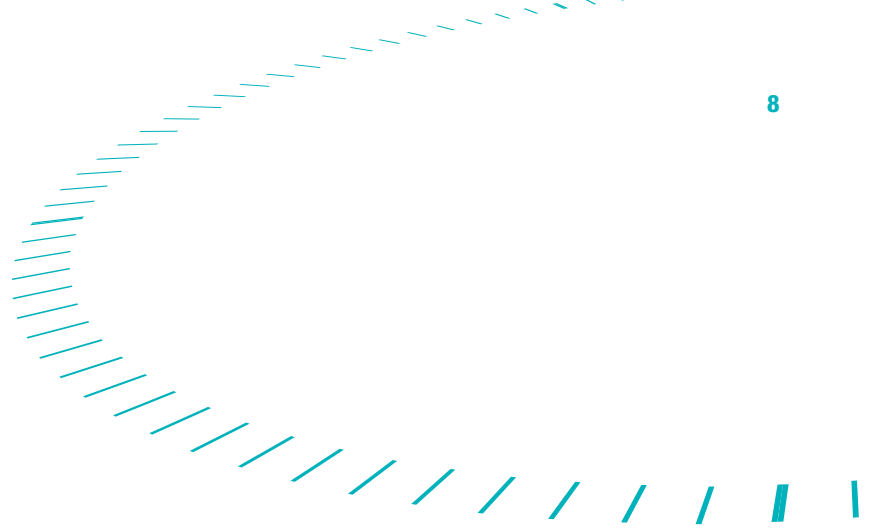
However, Ireland is required to implement the EU Directive for Institutions for Occupational Retirement Provision (IORP II) by January 2019. This will require pension funds to publish their position on ESG issues in their statements of investment policy principles (SIPPs), to consider these issues in their risk assessments and in their governance structures, and to provide details to prospective members on how these issues are taken into account. However, IORP II takes a 'comply-or-explain' approach, meaning that funds can comply by stating that they consider ESG factors not relevant to their fund.

In addition, on 24 May 2018, the European Commission published its first legislative package under its Action Plan for Financing Sustainable Growth. With regards to investor duties, the proposed regulation will introduce consistency and clarity on how institutional investors, asset managers, insurance distributors and investment advisors should integrate ESG factors in their investment decision-making process, as part of their duty to act in the best interest of clients. It also introduces uniform rules on how to disclose information to investors about their ESG integration procedures and about the extent to which ESG risks are expected to have impact on the returns of the product or service provided. In effect, the proposal is to move from the IORP II comply-or-explain approach to mandating that ESG factors must be taken into account and the process and impact disclosed.

Fiduciary duty and ESG-related legislation are just part of the regulatory picture. Interviewees noted that the emphasis on solvency and regular reporting is pushing Irish defined benefit pension funds to focus more on short-term investment performance, and to move away from risk assets and towards specific sovereign bonds – making ESG integration and focussing on long-term investment performance challenging.

The exact term fiduciary duty is not used in civil law jurisdictions, such as France or China. However, the term is well understood and equivalent obligations are set out in various statutory instruments. These are often referred to as investor duties

Many of the interviewees for this research pointed to their fiduciary duties (specifically, their duties to provide appropriate risk-adjusted returns for their beneficiaries) as important barriers to them paying greater attention to ESG issues in their investment practices and processes. Other barriers identified by interviewees include resource constraints, a lack of knowledge and understanding of ESG issues, misperceptions that ESG issues are purely ethical and competing organisational priorities (e.g. funding).



The pensions landscape in Ireland is also set to change. The regulator, the Irish Pensions Authority, has stated its intention to, over the medium term, cut the number of defined contribution occupational pension schemes from approximately 68,000 to around 100-150 active schemes. In addition, the Irish government is proposing by 2022 to develop and begin implementation of a state-sponsored supplementary retirement savings system in which workers will be automatically enrolled.

To date, responsible investment has not been a focus for Irish asset owners and, in turn, investment consultants. Large asset owners and investment consultants are now reviewing, or preparing to review, their approaches ahead of the introduction of IORP II. In contrast, many of the larger asset managers operating in Ireland have developed and implemented responsible investment strategies. However, outside of the larger players, market awareness or understanding of responsible investment and the relevance of ESG issues to investment remains limited.

IRELAND ROADMAP RECOMMENDATIONS

The legal reviews carried out prior to drafting this roadmap concluded that there is nothing in the Irish common law interpretation of fiduciary duty that would prohibit the adoption of responsible investment practices. Given the conclusion of the 2015 report that failing to consider ESG factors alongside other long-term value drivers would be a failure of fiduciary duty, the key question is what specific actions should be taken to modernise the interpretation of fiduciary duty in Ireland. Our recommendations are set out below.

Regulation

1. The Pensions Authority should ensure that the ESG-related provisions of IORP II are effectively implemented. In this context, we suggest that the Pensions Authority should:

- Issue guidance for pension funds and trustees as to how to ensure they are in compliance with the relevant provisions; and
- Set up a process for reviewing compliance and report annually on progress, lessons learned and the actions taken by the Pensions Authority where non-compliance is identified.

As a key element of its wider programme of work, the Pensions Authority should continue to raise standards of Irish pension fund governance and risk management, including asset allocation. ESG considerations should be an integral part of these efforts.

2. The European Commission's legislative proposal on investor duties signals a move to mandatory ESG integration in investment processes and decision-making, and to mandatory ESG disclosures by certain asset owners. To prepare the market for these new requirements, we suggest that the Department of Employment Affairs and Social Protection should give the Pensions Authority a leading role in encouraging greater focus on ESG factors for pension funds.

The aim of such engagement should be to ensure that, even in advance of the implementation of the EU legislation, the following actions are taken:

- Pension funds should commit to ESG integration and investee engagement in their statements of investment policy principles and in their investment strategies;
- Pension funds and their agents should integrate financially material ESG factors into their investment research and decision-making, consistent with the time horizons of their investments;
- Where pension funds delegate investment management activities to investment managers, they should incorporate ESG considerations into the selection, appointment and monitoring of these investment managers;
- Pension funds and their agents should engage with companies to encourage high standards of corporate governance and corporate responsibility;
- Pension funds should have a clear understanding of the interests and preferences of their members on ESG issues; and
- Pension funds should report on how they account for ESG issues in their investment practices and processes, including reporting on the outcomes that have resulted from these efforts.

These recommendations should ensure that Irish pension funds are well placed to comply with the EU legislation as it is enacted.

3. In line with the upcoming Commission proposals on investor duties described above, and with EU proposals that will require investment firms and insurance distributors to ask their clients about their preferences as regards ESG and to take these preferences into account when advising their clients, we suggest the Central Bank should issue guidance to encourage **asset managers** under its supervision to:
 - Have a clear understanding of the interests and preferences of their clients on ESG issues⁵;
 - Adopt responsible investment policies that commit them to integrating financially material ESG factors into their investment research and decision-making, and to engaging with companies to encourage high standards of corporate governance and corporate responsibility performance;
 - Integrate financially material ESG factors into their investment research and decision-making;
 - Engage with companies to encourage high standards of corporate governance and corporate responsibility; and
 - Report on how they take account of ESG issues in their investment practices and processes, including reporting on the outcomes of these efforts.
4. Given the impending proposed consolidation of smaller defined contribution pension schemes, it would be particularly timely for the Department of Employment Affairs and Social Protection (in conjunction with the Pensions Authority) to require all new pension schemes, including the **new master trusts** to adopt ESG integration, reporting and investee engagement, in line with the recommendations at point 2 (as relevant).
5. The organisation that will be responsible for the oversight of the **Irish pension auto-enrolment system**, scheduled to be introduced in 2022, should require all organisations or schemes responsible for the management of these funds to adopt ESG integration, reporting and investee engagement, in line with the recommendations at point 2 (as relevant).
6. The Department of Finance should ensure that **all public monies**, whether invested directly by a state body or managed on their behalf, are invested in line with responsible investment policies that commit them to ESG integration, reporting and investee engagement, in line with point 2 (as relevant). The Irish Strategic Investment Fund presents a best practice model that could be replicated by other funds.
7. A review should be carried out by the Pensions Authority of the interplay between the current funding standards and defined benefit pension schemes' consideration of ESG factors. The aim would be to ensure that funding standards do not conflict with long-term investment considerations and ESG integration, particularly in light of the EU policy direction on sustainable finance and long-term investing.

Capacity building

8. There is a need to raise awareness and build capacity across certain sectors of the Irish investment chain with regard to responsible investment. Specifically:
 - Pension fund trustees, asset managers and service providers should have knowledge of ESG issues and responsible investment, and should participate in formal training;
 - Responsible investment and ESG issues should be standard parts of trustee board agendas;
 - Other investors (e.g. high-net-worth individuals and retail investors) should be provided with information on ESG issues and responsible investment, and should be encouraged to develop their knowledge on these issues;

⁵ It is, however, recognised that it may be difficult to get a clear understanding due to a lack of consensus on ESG issues, even among very engaged asset owners. This challenge is magnified in the context of a pension fund, as there can be as many views as there are members. However, there are increasing regulatory requirements in this regard, and solutions are being developed to encourage client/beneficiary engagement.

- Case studies and examples of ESG issues and responsible investment best practices that are relevant to the Irish context should be developed and proactively communicated to the investment market; and
- The investment case for ESG issues and responsible investment, including that focusing on ESG issues as an integral part of investors' fiduciary duties, should be made to the Irish market in a balanced and objective way.

To ensure that a co-ordinated approach is taken and there is not significant duplication of effort, it is suggested that SIF Ireland should convene a roundtable in the second half of 2018 with interested domestic institutes and bodies to discuss how best to approach this capacity-building issue.

- Investment consultants have a key role to play in getting responsible investment on the agenda. They need to ensure that they have the organisational structures and systems in place to ensure that their local field consultants, who have direct contact with clients, have knowledge of ESG issues and responsible investment, to ensure that these issues are proactively raised with clients and to ensure that their clients develop and implement responsible investment strategies that align with the recommendations in this report.
- Institutional investors – including asset owners, asset managers, insurance companies and other government-supported bodies – should ensure they have adequate policies, skills, advice and systems for identifying and managing long-term systemic risks, such as climate change.

Stewardship and intermediation

- The Pensions Authority should, as part of its guidance on IORP II, encourage asset owners to make formal commitments to active ownership in their investment strategy⁶. This should include a commitment to include stewardship expectations in the selection, appointment and monitoring of asset managers.

Corporate reporting

- To make informed voting and investment decisions and to direct meaningful engagement activities, investors require timely, decision-useful information on a firm's operating performance and financial prospects, including ESG factors. Recognising the increasing levels of EU legislation and guidance relating to ESG disclosures⁷, we recommend that the following principles shape the Department of Business, Enterprise and Innovation's requirements for corporate disclosures:

- ESG factors should be disclosed within the annual report, with clear links between ESG factors and the company's business model and risk factors;
- ESG factors should, over time, be subject to the same levels of assurance as financial data;
- Companies should report using common performance metrics to allow for comparability; and
- Companies should also disclose additional company specific ESG risks and opportunities.

Finally, the Department of Business, Enterprise and Innovation should continue to promote and enhance the adoption of forward-looking and scenario-based frameworks on climate change with companies, including the recommendations set out by the TCFD⁸.

⁶ It is noted that most Irish pension funds invest in pooled funds rather than directly in company shares.

⁷ These include proposed changes to the guidance notes for the Non-Financial Reporting Directive to link it to the recommendations from the Task Force on Climate-related Financial Disclosures, as outlined in the Commission's Action Plan for Financing Sustainable Growth.

⁸ Task Force on Climate-related Financial Disclosures, see <https://www.fsb-tcfd.org/>.

THE EVOLVING LANDSCAPE OF FIDUCIARY DUTY, ESG AND RESPONSIBLE INVESTMENT

The European framework

As a member of the European Union, Ireland contributes to and is subject to and influenced by the legal regime and decisions of EU institutions.

The 2003 EU Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision⁹ requires occupational retirement provision (IORPs) to invest in accordance with the 'prudent person' rule, and to ensure that:

- Assets are invested in the best interests of members and beneficiaries or, in cases of a conflict of interest, in the sole interest of the members and beneficiaries;
- Assets are invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole, and are invested in a manner appropriate to the nature and duration of the expected future retirement benefits; and
- Assets are properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, and accumulations of risk in the portfolio as a whole.

IORPs are also expected to draw up and, at least every three years, review a statement of investment policy principles (SIPP). The SIPP should be made available to the competent authorities and, on request, to the members and beneficiaries of each pension scheme. There is no requirement to explicitly reference ESG considerations in these SIPPs.

Other EU directives that are relevant to responsible investment include:

- The 2014 Directive on the Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups¹⁰ (widely referred to as the Non-Financial Reporting Directive), which requires companies with more than 500 employees to disclose information on their policies, risks and outcomes as regards environmental matters, social and employee issues, human rights, anti-corruption, bribery and board diversity;
- The 2007 Directive on the Exercise of Certain Rights of Shareholders in Listed Companies¹¹ (commonly referred to as the Shareholder Rights Directive) which sets out minimum standards to ensure that shareholders have timely access to relevant information ahead of general meetings and are able to vote their holdings electronically. It also abolishes share blocking and introduces minimum standards for the rights to ask questions, to put items on the agenda of shareholder meetings and to table resolutions;
- The 2014 Directive on Markets in Financial Instruments¹² (MiFID 2) and the Regulation on Markets in Financial Instruments¹³ (MiFIR) which aim to make financial markets more efficient, resilient and transparent by: ensuring that trading, wherever appropriate, takes place on regulated platforms; introducing rules on high frequency trading; improving the transparency and oversight of financial markets; and by introducing robust organisational and conduct requirements.

⁹ [Directive 2003/41/EC](#)

¹⁰ [Directive 2014/95/EU](#)

¹¹ [Directive 2007/36/EC](#)

¹² [Directive 2014/65/EU](#)

¹³ [Regulation 600/2014](#)

Other noteworthy EU legislation in development is the 2017 Shareholders' Rights Directive¹⁴, which amends the existing 2007 Shareholders' Rights Directive¹⁵. The directive, which has to be implemented in national law by June 2019, will require institutional investors and asset managers to either develop and publicly disclose a policy on shareholder engagement, or explain why they have chosen not to do so.

From an ESG perspective, the revised EU Directive for Institutions for Occupational Retirement Provision¹⁶ (IORP II) is likely to have the most far-reaching effects. The directive, which needs to be transposed into Irish law by January 2019, will require IORPs to publish their position on ESG issues in their SIPP, to consider these issues in their risk assessments and in their governance structures, and to provide details to prospective members on how these issues are taken into account. However, the directive follows the 'comply-or-explain' approach, allowing an IORP to meet these requirements by stating that ESG factors are not considered in its investment policy and that the costs of monitoring ESG are disproportionate to the nature, scale and complexity of the organisation's [activities](#).

The Irish regulatory framework

Pension funds

For Irish pension funds, the 1990 Pensions Act and the investment regulations promulgated under the act provide the framework for their activities¹⁷. Beyond the Pensions Act, the guidance or other materials issued by the Pensions Authority (the government agency responsible for regulating pension schemes), and specific requirements in trust deeds and general trust principles guide the actions of trustees.

The Pensions Act defines the duties of trustees of schemes as, among other things, ensuring the proper investment of the resources of the scheme in accordance with scheme rules¹⁸. The Occupational Pension Schemes (Investment) Regulations, 2006, implement the specific provisions of the IORP Directive¹⁹. They require:

- Pension funds' SIPPs to include the investment objectives of the trustees, the investment risk measurement methods, the risk management processes to be used, and the strategic asset allocation implemented with respect to the nature and duration of pension liabilities;
- The assets of the scheme to be invested in a manner designed to ensure the security, quality, liquidity and profitability of the portfolio as a whole, so far as is appropriate, having regard to the nature and duration of the expected liabilities of the scheme; and
- The assets of the scheme to be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, and so as to avoid accumulation of risk in the portfolio as a whole.

More generally, trustees are expected to act as a prudent person would, to be loyal and to avoid conflicts of interest. However, these are implicit rather than explicit obligations, and it is difficult to tie these obligations back to specific clauses in the Pensions Act.

Pensions regulations in Ireland make no reference to ESG factors. There are no explicit obligations on pension fund trustees to take account of ESG issues, nor is there guidance encouraging them to do so. To date, the Pensions Authority has not provided any guidance on whether or not pension fund trustees may take ESG considerations into account when making investments.

¹⁴ [Directive EU/2017/828](#)

¹⁵ [Directive 2007/36/EC](#)

¹⁶ [Directive 2016/2341/EU](#)

¹⁷ See <http://www.irishstatutebook.ie/eli/1990/act/25/enacted/en/html>

¹⁸ Section 59, Pensions Act, 1990

¹⁹ [S.I. No. 294/2006](#), promulgated under Section 59(1) of the Pensions Act

While there is an absence of explicit reference to ESG considerations in Irish regulations and guidance, interpretation of the duties of prudence and loyalty require asset owners to pay attention to ESG issues in their investment practices and processes. The reasons are that: there is clear evidence that ESG issues can be financially material; sustainability-related trends mean that environmental and social issues are likely to be of even greater importance to companies and investors in the future; and more and more investors are making commitments to focus on ESG issues in their investment practices and processes, suggesting that a normative expectation is being defined²⁰.

The introduction of IORP II in 2019 will make trustee duties on ESG-related considerations much more explicit than is the case at present. The Department of Employment Affairs and Social Protection has responsibility for implementation of IORP II. The Pensions Authority will have responsibility for monitoring compliance with the relevant legislation and is expected to issue guidance that confirms and describes these duties.

The Pensions Authority is also developing its processes for scheme authorisation. It is likely that these will include annual supervisory meetings where the Pensions Authority will use codes and guidance – including guidance issued in relation to ESG and to trustee duties under IORP II – to structure its discussions with pension funds. Pension schemes will be required to demonstrate that they have followed a proper process in making decisions, and that the decisions they have made are reasonable.

One of the interesting features of the Pensions Authority's approach is that it will expect trustees to attend these meetings, without their investment consultants and their investment managers. The Pensions Authority's view is that Irish legislation is focused on trustees and, therefore, it is appropriate that it engages with trustees rather than their service providers. The Pensions Authority sees these meetings as providing it with the opportunity to ensure that Irish pension fund trustees are equipped to ask questions of and to challenge their advisors.

Asset management

There are currently no provisions in Irish fund or investment management²¹ legislation or regulation which expressly require that ESG factors be taken into account – or be disregarded – by the manager when managing an asset portfolio.

The requirement that does exist is to act in the best interests of the client and, linked to that, to have appropriate due diligence processes for selecting and monitoring investments. It is reasonable to believe that there will be circumstances where the best interests of the client will be served by taking ESG factors into account.

Funds and fund managers are subject to different legal requirements depending on their type and structure. In summary, the various pieces of legislation all require fund managers to act honestly, fairly and professionally, in line with the fund documents, contractual obligations and legal requirements. There are no obligations on fund managers to take account of ESG issues in their investment processes, other than when it is required by clients or is a part of the fund documentation.

This does not mean that ESG factors cannot be imposed by clients in the mandates they give to their investment manager. Furthermore, fund managers can adopt an ESG investment strategy where they see that such a strategy is appropriate for a particular mandate or for how it conducts its business more generally. In these situations, they should disclose this to their investors and be able to explain how the ESG investment strategy accords with their duty to act in the best interests of their clients.

20 These arguments are presented in greater detail in the [Fiduciary Duty in the 21st Century](#) report.

21 Although the terms asset management, fund management and investment management are often used to describe the same activity, the latter two are not always the same. In this report, we define fund management as collective portfolio management, i.e. the activity of managing collective investment schemes (or funds) to include the discretionary investment management function. Investment management refers to individual portfolio management, i.e. discretionary management portfolios on a client-by-client individual mandate basis.

The changing EU landscape

It is becoming increasingly clear that the introduction of IORP II is just the start of a greater regulatory focus at EU level on investors' duties and obligations in relation to ESG and sustainable investment.

The HLEG Report on Sustainable Finance

In 2016, the European Commission appointed a High-Level Expert Group (HLEG) on sustainable finance to develop a comprehensive set of recommendations for the financial sector to support the transition to a low-carbon economy. HLEG's [final report](#), which outlined specific recommendations and covering all aspects of the financial system (not just the investment sector), was published on 31 January 2018. One of its core recommendations was that, to better embrace long-term horizon and sustainability preferences, investor duties needed to be clarified in EU legislation. The HLEG noted that while IORP II requires pension providers to disclose publicly whether and how they include ESG factors in their risk management systems, it does not actually oblige them to take account of ESG factors in their investment policies.

The Commission Action Plan on Sustainable Finance

Since the release of the HLEG Report, developments have been swift; on 8 March, the Commission released its [Action Plan for Financing Sustainable Growth](#). The action plan includes a comprehensive list of tools and resources, such as: proposals for a taxonomy on climate change, environmentally and socially sustainable activities; standards and labels for sustainable financial products; support for sustainable infrastructure; mainstreaming ESG factors into market research and credit ratings; exploring how corporate governance can better enable sustainable finance; and enhanced oversight of sustainability by the European Supervisory Authorities.

Among the proposals particularly relevant from the perspective of this roadmap are:

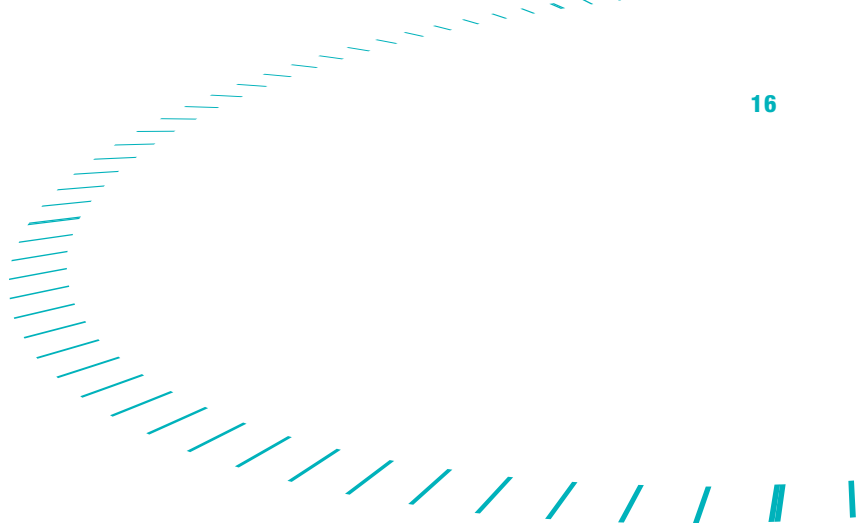
- Clarifying the duties of institutional investors and asset managers; and
- Incorporating sustainability in suitability assessments of financial instruments and insurance products.

The first legislative package under the Action Plan

On 24 May 2018, the Commission released the first legislative package under the Action Plan. There are four proposals, including the two noted above. This will be reviewed by the European Parliament and the European Council, which represents member state governments, with enabling legislation scheduled to be adopted from late 2019, and with elements entering into force six months later.

With regards to investor duties, the proposed regulation will introduce consistency and clarity on how institutional investors, asset managers, insurance distributors and investment advisors should integrate ESG factors into their investment decision-making processes as part of their duty to act in the best interests of clients. It also introduces uniform rules on how to disclose information to investors about their ESG integration procedures and about the extent to which ESG risks are expected to impact the returns of the product or service provided. In effect, the proposal is to move from a comply-or-explain approach, as in IORP II, to mandating that ESG factors must be taken into account and disclosed.

With regard to suitability assessments, the Commission has launched a consultation to assess how best to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients.



The EU Parliament perspective

On 30 May, Members of the European Parliament (MEPs) overwhelmingly supported a sustainable finance resolution. The vote, which indicates MEPs' position ahead of the development of legislation, was supported by 455 MEPs and opposed by 87, with 92 abstaining.

In conclusion

The planned acceleration of regulatory action in relation to sustainable finance in the EU is highly ambitious. The Action Plan clearly sets out the Commission's game plan for making financial markets in Europe more sustainable and climate-resilient. Investor duties and sustainability (or ESG) preferences are top of the to-do list. EU regulation is on the way, and the Irish investment community, including policymakers and regulators, needs to ensure that it is in the best position to react and respond to any upcoming regulatory changes in relation to the ESG agenda.

While the EU will drive the sustainable finance agenda in part through regulation, the underlying impetus for sustainable finance is closely linked to the need to make the real economy more sustainable. The financial sector has a key role to play in helping to deliver the ambitious objectives set out in the Paris Agreement on climate change and in the UN Sustainable Development Goals.

ESG AND FIDUCIARY DUTY IN THE IRISH CONTEXT

Market structure

Ireland and international financial services

The Irish financial services sector operates in an international context and within a European regulatory system. Ireland is recognised as a leading global centre for international financial services, specialising in a variety of activities ranging from fund administration to aircraft leasing. The country is now the seventh largest provider of wholesale financial services in the EU²². From a standing start in the 1980s, there are now more than 400 companies employing almost 40,000 people in the sector²³. The Irish asset management industry had €4.4tn in assets under administration in April 2018²⁴, and 20 of the world's top 25 financial services companies now have operations in the country²⁵.

However, a distinction needs to be made between international players and the domestic investment landscape. While Ireland is an important domicile for the funds sector, the substantial majority of assets and liabilities are non-domestic. All of the interviewees for this report agreed that, to date, the demand for ESG integration has been primarily driven by international rather than domestic clients.

Domestic investment landscape

Almost 60% of wealth in Ireland is owned by those over 55, and the largest components of tangible household wealth are the main residence and farms²⁶. Figures from the Central Bank show that, as of the end of 2017, household net worth reached €726.8bn at the end of 2017, or €152,000 per capita. After housing, the next most important form of wealth is pension rights.

In the domestic investment landscape, the key institutional investors are the national sovereign wealth fund, the Irish Strategic Investment Fund (ISIF), domestic pension funds and insurance companies.

It is worth noting that the Irish state pension system operates on a 'pay as you go' basis, meaning that today's pensions are not funded by past contributions made by today's pensioners but are instead funded by the taxes and social insurance contributions of today's workers. This applies to all public sector pension funds, including those provided by local authorities.

At the end of 2016, Irish occupational pension funds had €125.5bn in assets under management (AUM). Of these assets, €78bn were in defined benefit (DB) schemes and the remaining €47.5bn in defined contribution (DC) schemes²⁷. The ISIF, meanwhile, manages €8.0bn, with a statutory mandate to invest, on a commercial basis, in a manner designed to support economic activity and employment in Ireland.

There are approximately 10-12 schemes in Ireland with more than €1.0bn in assets. These are primarily the schemes of state-owned enterprises such as ESB, CIE and An Post, and of banks such as AIB and Bank of Ireland. These larger schemes tend to have internal resources and make their own tactical and strategic decisions. However, beyond these, most pension funds tend to rely on investment consultants and invest in pooled funds. Interviewees indicated that these pension funds tend to assume that their investment managers will deal with issues such as voting, corporate governance and class actions.

At the other end of the scale, there are approximately 68,000 DC occupational pension schemes, known as Personal Retirement Savings Accounts. The Pensions Authority has stated its intention to, over the medium term, significantly cut this number, possibly to about 100 - 150 (which may be master trusts or vehicles that offer personal retirement savings accounts or PRSAs)²⁸.

22 <https://www.idaireland.com/doing-business-here/industry-sectors/financial-services>

23 http://www.finance.gov.ie/wp-content/uploads/2017/05/17-01-16-IFS2020-Action-Plan-FINAL-for-web_0.pdf

24 https://irishfunds-secure.s3.amazonaws.com/1523283637-2018-04-IF_WhyIreland_Brochure_euro_April-2018.pdf

25 <https://www.idaireland.com/newsroom/publications/financial-services-in-ireland>

26 <http://www.publicpolicy.ie/distribution-of-wealth-in-ireland/>

27 Irish Association of Pension Funds (IAPF) (2017), IAPF Pension Investment Survey 2016 (IAPF, Dublin). <https://www.iapf.ie/publications/surveys/annualinvestmentsurvey/default.aspx?id=687>

28 See https://www.pensionsauthority.ie/en/News_Press/News_Press_Archive/The_Pensions_Authority_summary_of_2017_regulatory_activity_and_plans_for_2018.html

There are a number of reasons why the Pensions Authority wants to pool these schemes:

- It would provide economies of scale and would put pressure on pension providers and asset managers to reduce fees, thereby delivering savings for members;
- It would lead to higher standards of governance. The Pensions Authority's view is that bigger schemes are more likely to be better governed, to have better processes and to attract more qualified trustees; and
- It would enable the Pensions Authority to more effectively oversee the pensions system as a whole and increase the likelihood of wrongdoing being detected.

Outside of domestic pensions savings, we do not have accurate figures on how the balance of wealth in Ireland is distributed across Irish asset owners, but the broad categories include high-net-worth individuals, family offices, religious congregations, charities and not-for-profit organisations, trusts and endowments.

Domestic regulation

Interviewees agreed that there are, at present, no explicit legislative requirements on pension funds or on asset managers to take account of ESG factors in their investment research and decision-making processes. Some interviewees did acknowledge that their fiduciary duties of loyalty and prudence did mean that they, or their investment managers, should at least account for material ESG factors in their investment decision-making; however, most also acknowledged that, in practice, these factors currently receive relatively little attention. Some interviewees summarised the present situation as one in which there is an absence of clear legal duties in either direction, i.e. there is no positive legal duty to take account of ESG factors but, equally, there are no explicit legal barriers.

Interviewees agreed that the introduction of IORP II will change the situation by requiring pension schemes to say whether they consider ESG factors in their decision-making and, if so, how they do so. Views were divided on the significance of the changes being introduced. A number of interviewees commented that the real impact of IORP II on investment practice will depend on how rigorously it is implemented and enforced. Others noted that, in many ways, IORP II simply codifies standard market practice; in that context, they consider that most of the changes are related to administration and reporting, rather than fundamentally altering investment practices and processes.

Fiduciary duty

While IORP II is recognised as an important influence on how investors treat ESG issues in their investment practices and processes, many of the interviewees pointed to the importance of fiduciary duty as a driver and influence on how they manage their investments. Interviewees agreed that protecting the needs and interests of beneficiaries is the core responsibility and obligation of fiduciaries. Some, as discussed above, acknowledged that the fiduciary duties of loyalty and prudence did mean that they should pay attention to financially material ESG factors in their investment decision-making.

It is interesting to note that the language of responsible investment and ESG may not be helpful. Some interviewees, including a number who were clear about the importance of taking account of material ESG issues, expressed concern that a focus on ESG considerations could compromise their investment returns and potentially conflict with their fiduciary duties. When we explored these views more deeply, we found that they were often referring to 'ethical' or 'screened' investments, rather than ESG integration. Some comment that this apparent conflict was being raised by legal advisers rather than by investment consultants or other investment professionals.

Market practice

Before looking specifically at ESG issues, it is worth noting that the Pensions Authority has spoken publicly about the importance of strengthening governance and the quality of risk management within the Irish pensions fund sector. These are current priorities for the Pensions Authority, which is increasing its scrutiny of pension funds and is supporting plans for pension fund consolidation in the Irish market.

Among Irish asset owners, responsible investment is in its infancy. In this regard, it should be noted that Irish pension funds have had significant challenges since the Global Financial Crisis, both from a funding and a regulatory perspective (particularly with regards to DB schemes). The time and resources that they have had to devote to responsible investment has necessarily been limited. Also, the vast majority of Irish pension funds invest through funds rather than direct shareholdings.

Apart from the ISIF, which has a long-standing commitment to responsible investment²⁹, asset owners do not appear to have adopted formal policies on responsible investment or to have formally integrated ESG or responsible investment considerations into their manager selection, appointment or monitoring processes. Large asset owners are, however, reviewing, or preparing to review, their approaches ahead of the introduction of IORP II. The actions that are being taken include reviewing investment strategies, surveying investment managers on their approach to responsible investment, trustee education and training, and asking investment consultants for advice on how they might respond to IORP II.

Most asset owners delegate investment management to investment managers. They rely on these managers to take due account of ESG issues and to engage and vote appropriately. However, there appears to be limited scrutiny by Irish asset owners of how their asset managers discharge these responsibilities.

Many of the larger asset managers located in Ireland have developed and implemented responsible investment strategies. These asset managers have been proactively advertising their capabilities and encouraging their clients to pay more attention to ESG in manager selection processes. However, outside the larger managers, there is arguably a lack of expertise regarding responsible investment and ESG, in so far as it relates to domestic asset owners and their advisers. There are currently only eight PRI signatories in Ireland (five asset managers, two asset owners and one service provider). Market awareness or understanding of responsible investment and the relevance of ESG issues to investment remains limited in certain quarters.

Many asset owners rely on investment consultants for advice on a wide range of investment-related issues. These consultants are therefore likely to play a key role in putting responsible investment on the agenda for Irish asset owners. The larger investment consultants have significant organisational knowledge in their international businesses in relation to responsible investment. In the interviews conducted for this project, these consultants indicated that they are currently building their Irish capabilities and services on ESG and responsible investment. They are starting to raise responsible investment with their clients, encouraging them to adopt ESG and responsible investment policies, and ensuring that these policies are effectively implemented (e.g. in manager monitoring processes and client reporting). Part of this process involves educating clients on the need to adopt ESG or responsible investment policies, and on the investment case for focusing on ESG issues (in a balanced and objective way).

Some interviewees noted that this is new, and that field consultants have not, at least to date, been proactively raising these issues with their clients³⁰. Others noted that consultants need to offer advice and services tailored to the local regulatory environment and to the needs and interests of their clients; the absence of client demand and regulatory push on ESG has limited the incentive for investment consultants to focus on this area.

²⁹ The ISIF's predecessor was a founding signatory of the PRI and continues to show leadership and innovation in relation to the responsible investment agenda. However, the ISIF's mandate is very specific, it is subject to more scrutiny than occupational pension funds and its investment approach may not be suitable for other asset owners.

³⁰ The mirrors the findings of the PRI's analysis of the global investment consulting industry. See Martindale, W. & Slebos, M. (2017), [Investment Consultant Services Review](#).

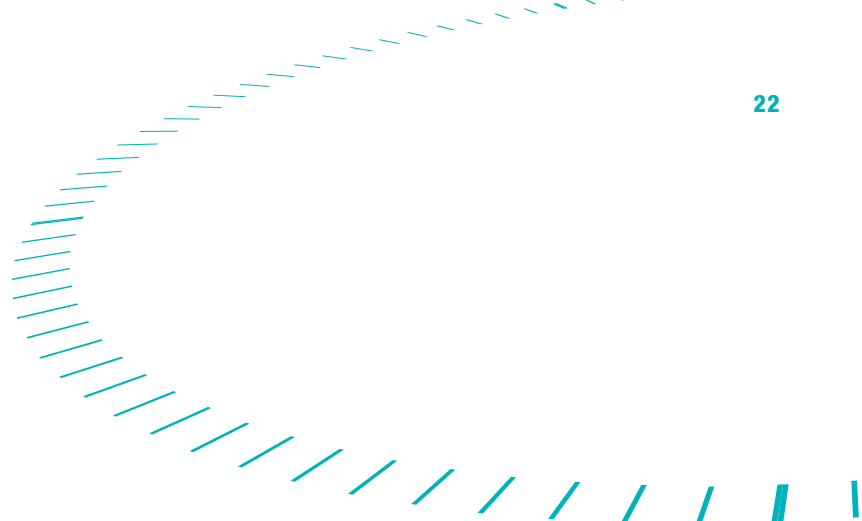
Wider considerations

While the primary focus of the interviews was on how the law informs and shapes investment practice, our research points to a number of other factors that influence – both under prevailing legal conditions and under the conditions likely to prevail once IORP II has been introduced – how investors treat ESG issues in their investment practices and processes, namely:

- Irish institutions tend to be conservative and wary of being first movers. Examples of good practice and effective implementation (including evidence of the positive contribution to investment performance) are important to encourage change and the adoption of new practices;
- Much of the discussion on ESG and responsible investment has focused on the potential contribution of ESG integration (or the explicit analysis of these issues in investment research and decision-making) to investment performance, rather than on the wider contribution of responsible investment (which includes company engagement and public policy engagement) to enhanced short and long-term investment performance. This also reflects the emphasis on diversification (across asset classes, across companies) as an integral element of how Irish pension funds meet their fiduciary duties;
- There is a lack of awareness of what ESG issues and responsible investment mean in practice, with interviewees noting that inconsistencies in terminology and the common conflation of responsible investment and ethical screening are particular barriers to progress;
- There is limited understanding among beneficiaries of how to engage with pension funds; the jargon and technical complexity of pensions act as significant barriers to engagement. From a pension fund perspective, gauging members' views is seen as difficult, and it is difficult to offer concrete choices to members on ESG and responsible investment;
- Fiduciary duty and ESG-related legislation are just part of the regulatory picture. The emphasis on solvency and regular reporting under the pensions funding standard is pushing asset owners to focus more on short-term investment performance and to move away from risk assets and towards bonds. A number of interviewees commented that regulation needs to encourage long-term investment;
- The question of the nature and quality of disclosure of ESG information by Irish companies was not raised by any of the interviewees. Bearing in mind that Irish investors typically invest only a small percentage of their funds in Irish companies, this may not be as important for Irish investors as it is in other markets. However, it is important for Irish companies to engage on this topic given the increasing investor focus on this agenda at a global level; and
- By 2022, the Irish government is proposing to develop and begin implementation of a state-sponsored supplementary retirement savings system in which workers will be automatically enrolled.

CREDITS

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About the PRI

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions. The six Principles were developed by investors and are supported by the UN. They have over 2,000 signatories from over 50 countries representing US\$80trn of assets. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system. For more information, see www.unpri.org.

About UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector founded in 1992. UNEP FI works closely with over 200 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. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations. For more information, see www.unepfi.org.

About The Generation Foundation

The Generation Foundation is the advocacy initiative of Generation Investment Management, a boutique investment manager founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for sustainable capitalism. Its strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for sustainable capitalism, and to persuade them to allocate capital accordingly. For more information, see www.genfound.org.

