PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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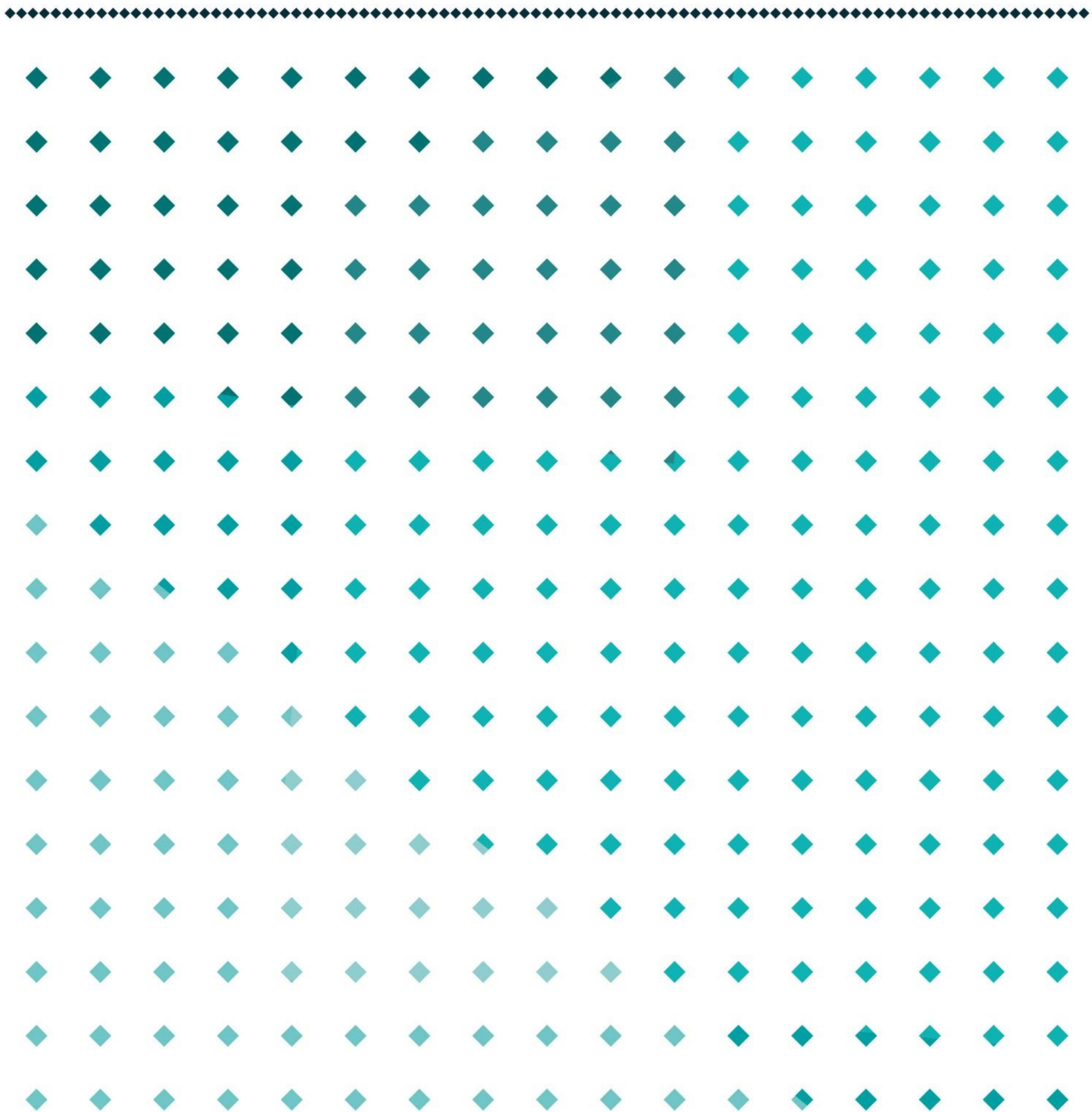
CONSULTATION RESPONSE: EUROPEAN COMMISSION: LONG-TERM AND SUSTAINABLE INVESTMENT



PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

We're the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

1. RATIONALE FOR ESG INCLUSION IN INVESTMENT DECISIONS

1.a. Do ESG factors pay a role in the investment decisions of investors? If not, why?

If yes, please specify which considerations are reflected in your investment policy and mandates? In what form is this commitment expressed?

European pension funds recognise that with their long-term investment horizons, a key consideration must be to look both at both the returns on their investments and any associated risks.. The variety, in both type and scale, of pension funds does however lead to a large diversity of responsible investment policies. Social returns are not a substitute for financial returns, but many funds express an ambition to generate social returns without compromising financial returns.

ESG factors play a key role in the investment decisions of investors. This role can be diverse as there is a **wide interpretation** of what 'ESG' means across pension funds and the wider investment community. Including ESG factors in investment decisions can take different forms, e.g. screening, integration, engagement.

Investors can for example draw up negative lists specifying what they do not want in their portfolio, e.g. companies using child labour, companies which produce (chemical) weapons, bonds issued by non-democratic countries etc. Another way of incorporating ESG factors for investors is to engage with the companies they invest in, be active shareholders and thereby influence the behaviour of the companies in question. It is the decision of the investor how much time and effort is used to pursue these or other approaches, leading to very different strategies and results.

Occupational pensions are mostly linked to a sponsoring employer and sometimes also to the social partners of a specific industry. The sponsoring employer and social partners can play a decisive role in the inclusion of ESG factors in the investment decision of the pension scheme.

The **economic environment** influences the commitment of pension funds, whose primary responsibility of strategic investment decisions is to maximize the returns and to fulfil the pension commitments for the members. For instance, the current low interest rate environment has had an impact on the returns a pension scheme may achieve through a typical portfolio, hence it may influence the extent to which ESG factors are taken into account when 'chasing yield', especially when conducting ESG research often triggers higher costs.

The role ESG factors play in investment decisions also depends on **the asset class.** ESG factors play a larger role in equities, fixed-income corporate bonds and real assets.

When pension funds outsource their investment management, the level of consideration of ESG factors also depends on the agreed mandate and its governance, as well as the asset managers' policy and expertise.

A number of pension funds will reference ESG in SIPs, and quiz managers in requests for proposals however this is not a universal practice. To some extent, it depends on the knowledge and capacity of the trustee, but there is also something of a 'chicken and egg' problem, in that the pension fund administrators need some initial feedback from investment managers on the ESG impact of their investments (and the investment managers need to be willing and able to provide this) before the funds can make more informed stipulations in their mandates.

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

a) risk management:

b) alignment of investment policies with the long-term interests of beneficiaries of the institutional investor,

c) pressure from clients on whose behalf the institutional investor invests funds,

d) seeking a positive social or environmental impact of investments,

e) ethical considerations,

f) legal or regulatory constraints, please specify,

g) other, please specify.

Please provide an explanation :

- All apply, but b) the most influential

2. INFORMATION ON ESG RISKS AND OPPORTUNITIES

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

Examples include…

- Poor governance structures or processes;
- Climate change threatens the viability of fossil-fuel sectors/extractive industries/energy intensive industries – and threatens wider economic stability. Is there a plan for addressing climate change in place?

- 'People risk' – high staff turnover; industrial conflict; skills shortages; disengaged workforce all critical to successful companies producing healthy returns for investors
- Reputational risk: how companies comply with labour law and treat their employees (reputation risk), fines and long-term antagonism of key stakeholders (eg regulators, suppliers) can result from factors like aggressive tax planning, human rights abuses, poor labour or health and safety standards across supply chain**.**

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

There are a number of ESG products and specialist providers servicing the investment community, such as ESG indexes or specialist researchers/consultants, in addition to responsible investment/stewardship/ESG teams at asset managers and investment consultants. However, while both the quantity and quality of ESG research is improving, the link to financial performance is not always made explicit. Much of the 'sell-side' analysis that investment managers used to inform their decisions does not cover ESG issues.

A lot of the information on (potential) investee companies ESG performance comes from the reports produced by the companies themselves, although the space dedicated to ESG issues varies from company to company. Independent research by NGOs can also offer an alternative perspective.

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

Many of our members tell us that they concentrate much of their investment in passive investments that track a particular index or benchmark. Active investment strategies that calculate and take into account ESG information can involve higher total costs for the pension fund than passively managed investments.

Another difficulty of the access to information concerns the low comparability of information provided by different sources. Not all companies publish this type of information, and if so, it might not be complete. Different actors analyse the issues and publish the information in different ways, making it difficult to compare. This is partly a problem of differences between the rules of the different jurisdictions in which companies are headquartered.

Finally, it is also worth noting the 'unknown unknowns' –the question pre-supposes that investors are sufficiently informed to know that ESG risks exist and to seek information highlighting the extent of these risks. This is not always the case, particularly across smaller pension schemes run by small or medium-sized employers – a lack of awareness of potential ESG risks can prevent pension funds from seeking information on the subject

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

Indeed, gaining access to quality data entails additional costs, which will depend on the type of information needed.

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

There are many factors that may discourage companies from disclosing data, such as the lack of standardised systems in place facilitating such disclosure; the lack of demand; data protection issues and commercial sensitivity (eg companies might derive competitive advantage from innovative approach to human capital or resource management they'd be unwilling to disclose to competitors); the lack of standardised procedures of how and what information should be disclosed.

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

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

All relevant, but most obviously a)

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

In some areas there is sufficient accountability for the disclosure by companies of such information, but this is not always the case. While some hard information such as data on water use or CO_2 emissions can be measured, activities to improve e.g. governance or labour conditions are less tangible. In areas where it is difficult to measure improvement, greenwashing might occur. Furthermore, often it is difficult to form coalitions with sufficient weight to represent proper accountability.

In addition to this, we would like to note that the reliance on company annual reports (particularly for non-financial information) might be problematic, given this is disclosed by the company and does not include a third party verification.

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

Three examples of useful guidelines are as follows:

- The European Federation of Financial Analyst Societies (EFFAS) and the Deutsche Vereinigung für Finanzanalyse und Asset (DVFA, Society of Investment Professionals in Germany) published in 2010 a "Guideline for the Incorporation of ESG into Financial Analysis and Corporate Valuation". The Guideline includes Key Performance Indicators for ESG, building on the requirements of investors. The

Guideline was published after a three year discussion process with a network of investment professionals and experts around the world.
- In the UK, the Red Line Voting initiative (http://redlinevoting.org/) which was developed by the Association of Member Nominated Trustees (AMNT) to enable pension schemes to take a more active asset ownership role – to become more responsible investors.
- In Germany, In September 2013 the Deutsche Börse Group published a paper on "Communicating Sustainability. Seven Recommendations for Issuers (Summary)". The Recommendations were developed by market participants for market participants and are supported by a number of German associations.

General principles of best practice include responsibility for ESG reporting at senior level and independent verification of disclosure (in the case of the 'social' element of ESG, this could include employee input into company reporting).

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

This is an interesting asset class for investors – assets that can generate a return while also serving wider economic/environmental need are likely to be attractive to savers who want their money to be used positively as well as generating a return. It's possible that this form of investment could even encourage more people to save money. However, trustees are only likely to consider these investments if they offer comparable returns to other offerings, otherwise they will find them difficult to justify.

Specific ESG investment instruments offer diversification and can offer yield enhancement. On the other hand, it might be too early to say due to the limited size of this market.

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

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

An appropriate long-term risk assessment methodology should include concrete metrics for measuring performance (e.g. carbon footprint, staff turnover) and foresee regular engagements with company to understand qualitative narrative behind data. In addition to this, the assessment methodology should identify factors likely to lead to costly ESG failure – e.g. Volkswagen/LIBOR-rigging malpractice; reliance on a business model that is irreconcilable with international greenhouse gas reduction commitments; workforce issues – and then establish metrics for measuring these factors and processes necessary to safeguard against them – e.g. policies on whistle-blowers, independent directors with necessary expertise. The risk assessment methodologies could also score investee companies against it.

While being far from a concrete risk assessment methodology, the UN Principles on Responsible Investment (PRI) are an example of good practice. They can operate as a fall-back option for those pension funds that have not developed their own catalogue of principles. The PRI provide specific examples of responsible investment practices that can be fully or partly integrated into investment strategies.

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

Mis-alignment of timeframes can be a hindrance to incorporation of ESG risks – many environmental or social issues take a long time to crystallise. Investments – and the performance of people making them – may be assessed and rewarded over a much shorter period. Therefore, the market does not factor them into investment decisions and they do not have an effect on the share price – until the point they manifest themselves in a major social or environmental incident.

Other possible barriers include:

- The outsourcing of day-to-day investment decisions to external asset managers, with the investors not providing additional indicators relating to ESG factors.
- Intransigence, on part of companies and/or inconsistent reporting requirements also makes it difficult to access the measures necessary to assess risk.
- Despite a growing volume of research evidence showing that ESG factors are financially material to investment returns, investors are not always sufficiently informed to know that ESG risks exist and that they should seek information regarding the extent of these risks. This lack of awareness of ESG risks remains a barrier to ESG integration.

4. INTEGRATION OF ESG ASPECTS IN FINANCIAL INCENTIVES

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

If an investor wants ESG factors to be taken into account by external managers, this will be specified in the requirements for the asset manager. It is not taken into account in isolation, but must be based on overall performance.

Our Stewardship Survey of UK pension funds found that 67 per cent of respondents include the approach to ESG in the statement of investment principles and 63 per cent questioned

prospective managers about their stewardship practices. It should be noted that respondents to our survey are self-selecting. The fact they are sufficiently engaged to take the time to complete the survey suggests that for UK pension funds, they represent best rather than typical practice.

The Association, together with members, has produced a guide to responsible investment that offers advice on this subject http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0424_guide_to_responsible_investment_reporting_in_public_equity_published.pdf. Statutory and Industry/Civil society guidelines, such as the UK Stewardship Code and the UN Principles of Responsible Investment also offer assurance of good stewardship and ESG practices to institutional investors

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

No, because ESG performance is difficult to extract (in many cases there is no distinction between ESG-mandates and non-ESG mandates).

In some cases, pension fund employees may receive performance-related bonuses for general performance, which would cover stewardship and ESG or when the role is linked to oversight of responsible investment or stewardship.

5. CAPACITY OF INSTITUTIONAL INVESTORS

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

UK pension funds come in a variety of sizes, with different ability to dedicate resource to ESG issues and manage their mandates to investment managers. Larger, more sophisticated schemes will have greater capability but the majority are linked to SMEs and will have to make choices about how to dedicate resource.

The UK pension funds that engage most closely with the Association's work on stewardship tend to be larger. Economies of scale make it easier for funds to, to employ staff dedicated to responsible investment, for example.

Larger institutional investors also have larger shareholdings in companies, or represent a more substantial component of asset managers' business. Therefore engagements carry greater weight.

And large investors require fewer partners in co-ordinated engagements to have an effect – this could make engagement/stewardship logistically easier.

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

Kitemarks introduced by Governments or industry/civil society such as the UK Stewardship Code or the UN PRI have advanced the awareness and understanding of ESG factors in investment.

Institutional investors' capacity and ability to integrate ESG factors has been improved by the growing number of services and products designed to support ESG related investment and stewardship activities, as well as by campaign groups such as Share Action which have advanced the awareness and understanding of ESG factors in investment.

In the Netherlands, Eumedion, a corporate governance forum, has defined 10 best practices on engaged share-ownership for institutional investors that many of our Dutch members support and adhere to. The document can be found on Eumedion's website.

6. INTERNAL GOVERNANCE AND ACCOUNTABILITY OF THE INSTITUTIONAL INVESTOR

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

ESG factors tend to matter in the long term rather than in the short run. It is therefore important to set long-term goals rather short-term performance measures.

As with any other objectives, senior beliefs and convictions are crucial. In this context, the expertise of the Board has a significant impact.

In the Netherlands, the Code of the Dutch Pension Funds which entered into force in 2014 set the standards for good pension fund governance and covered themes such as integral risk management, remuneration, diversity and sustainable investment.

Finally, representation for and accountability to beneficiaries in governance structures can help achieve alignment of interests.

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

Many pension funds can provide detail on ESG risks as requested, but it is not common for beneficiaries to take an interest in this subject. However, research conducted by the Association found that for the 18-34 age bracket, a similar number of people thought that the record of a company's treatment of its workers was as important as its financial performance in assessing its merit as an investment proposition. Research for Price Bailey LLP found that 43% of those surveyed would not have wanted their money invested in an unethical company, even if it offered superior investment returns. Therefore, it is reasonable to think that demand for disclosure of ESG information is likely to become more commonplace, and that if it is not currently widespread, this relates more to a lack of awareness of how pensions investment works in practice than a lack of interest.

Some examples of best practice include disclosure of responsible investment strategy (for example, voting record) online and in an annual report to members; and face-to-face meetings and pension 'AGMs'.

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

See question 6b – currently low levels of pro-active engagement with pension funds on these issues, but survey evidence consistently shows that people want their pension fund to invested in a socially and environmentally sustainable fashion. This suggests that perceived lack of engagement largely results from a lack of awareness of how pensions investment works and the important role that it plays in shaping the economy, society and the environment. It seems less likely that beneficiaries simply don't care about responsible investment issues.

7. THE ROLE OF OTHER SERVICE PROVIDERS

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

Our stewardship survey reports that just 29 per cent of investment consultants raised ESG issues with respondents. This suggests a low level of provision of advice on sustainable/responsible investment. Funds that don't know to demand ESG information miss out.

Our members have also highlighted the conflicts of interest involving investment banks that provide sell-side research to investors and advice to the corporates. This may make them less likely to offer critical analysis of companies' ESG record.

The resources of pension funds are also a potential barrier to good quality investment research on ESG issues – if they can't afford to commission it, there is no demand for others to supply it.

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

Variable – in general, analysis is much more likely to focus on conventional factors (cashflow, return on investments etc) than ESG factors, unless there has been a major ESG issue.

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

See 7a) – ESG issues are raised in a minority of cases. This is a critical issue as pension funds rely heavily on investment consultants and therefore their failure to engage with ESG issues means that stewardship and ESG issues are less likely to be incorporated into investment strategies

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

Again, there is significant variation by sector and by market. It's also worth noting that proxy advisors 'default' voting policies might not incorporate ESG criteria but they may be able to tailor their positions for clients that mandate a stronger focus on ESG.

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

Some credit rating agencies (e.g. Moody's) have started to incorporate ESG issues in their work. However, credit markets remain a long way behind equities in terms of ESG integration, even though equities still has a lot of room for improvement.

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

Reliance on companies own disclosures via the annual report ought to be a concern. Robust external verification using common performance measures to ensure comparability is

important. Thus far, different reporting requirements in different countries, and assorted 'kitemarks' (e.g. living wage accreditation) make assurance a somewhat piecemeal process.

8. THE ROLE OF NON-PROFESSIONAL INVESTORS

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

N/A

9. LEGAL OR REGULATORY CONSTRAINTS

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

We believe that forthcoming guidelines in UK suggesting that screening/divestment policies should reflect objectives of UK Government foreign policy are a concern**.** Generally, however, we do not believe rules on fiduciary duty represent an impediment to integrating ESG into investment decisions. While the UK Law Commission's review of fiduciary duty in this country does not enable pension fund trustees to use investments to pursue their own personal or political goals, the Law Commission make clear that pension fund investment strategies may incorporate financially material ESG considerations and those that will not significantly affect financial performance and/or reflect the wider view of the membership.

However, our members have raised regulations on solvency and liquidity as a barrier to ESG integration. As noted in response to question 3b, correlation between the ESG and financial performance of an investment is stronger over the long-term, however liquidity and solvency requirements may encourage a higher turnover of assets. In which case the case for ESG integration into investment strategies becomes weaker.

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

Where this is the case, it is the result of a mistaken belief that integration of ESG considerations equates to the loss of investment returns and therefore contravenes fiduciary duty. It is possible that this is the result of a) a deliberate, ideologically-drive misunderstanding; or b) a general lack of knowledge/capability compounded by investment consultants failure to highlight the importance of ESG issues, both of which would be concerning.

10. OTHERS

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

N/A

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

In order to be able to make investments into e.g. renewable energy and infrastructure, a stable and clear policy framework is essential. The European Commission could play an important role in the support and promotion of existing standards for assessing the sustainability and governance performance in different asset classes such as real estate and could encourage efforts to build a common standard for infrastructure assets. A strong price on carbon and avoidance of retroactive changes to subsidies and tariffs would also protect confidence both in current green energy/infrastructure projects and also future investments that depend on consistent policy.