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European Commission's Action Plan: Financing Sustainable Growth

Response by the

EIOPA Occupational Pensions Stakeholder Group

Introduction

1. The Occupational Pensions Stakeholder Group (OPSG) welcomes initiatives by the European Commission (EC) to support the financial sector in facilitating sustainable growth. Since pension investments tend to be long term oriented, they are useful for transforming short term perspectives to risk and return into long term perspectives. Thereby, pension investments can contribute to the transition towards sustainable finance[1].
2. The OPSG recognizes that the situation with respect to sustainable pensions and investments differs substantially across the EU member states. The OPSG Feedback Statement to EIOPA Questionnaire on the Consumer Trends Report of March 2018 reports on several differences:
    a. In some member states, pension funds have to report on their ESG investments, or on their approach regarding ESG aspects, while in other member states this is not mandatory;
    b. There are cases of 'greenwashing' in which investment funds claimed to be ESG superior, while in fact their composition and performance was not sustainable;
    c. Attempts to gauge plan members' preferences for sustainable investment were not successful yet, in some cases due to the intrinsic problems of preference measurement and in other cases due to financial illiteracy of plan members.
3. Given the variety of situations in the member states, the following remarks on the EC Action Plan (COM 2018 / 97 final) do not always represent the full OPSG point of view. In other words: a differentiated approach may have more impact than a one-size-fits-all approach in terms of enhancing the sustainability of pension investments. Still, some minimum standards as well as an operationalization for the entire Internal Market may be helpful. A taxonomy is part of such operationalization.
4. The OPSG has also noted that the EC proposal on the regulation of the European Parliament and of the Council (COM 2017 / 536 final) mentions in its chapter 5 that the ESAs *"will be under an obligation to take account of risks related to environmental, social and governance factors when carrying out their tasks"*. Moreover, *"This will also enable the ESAs to monitor how financial institutions identify, report, and address risks that environmental, social and governance factors may post to financial stability, thereby rendering financial market activities more consistent with sustainability objectives."*
5. The combination of both the EC proposal on the role of the ESAs and the EC Action Plan for the financial sector prompted the OPSG to collect and share its views from the pensions perspective. Although pensions as such are a labour condition, their management has an intrinsic financial dimension[2].

Environmental, Societal and Governance (ESG) goals

6. The EC starts the action plan with a clear case for long term investing and ESG considerations. Insofar as sustainable investment can be translated into Environmental, Societal and Governance goals, the balance between the three is hard to strike. Currently, most policy insights and actions are geared towards the 'E': climate change, resource depletion, and

[1] In this document, the terms "sustainable" and "sustainability" are supposed to refer to sustainability in the environmental, as well as the social, and governance dimensions.

[2] This paper was drafted well before the Commission legislative proposals on sustainable finance were released. Therefore, they are not discussed here. (See https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en)

environmental degradation (such as irrevocable losses on biodiversity)[3]. These environmental challenges can sometimes be framed into risks, which can make them compatible with other risks in the risk-return framework of investors.

7. The advantage of the EC's approach is that analysts can (further) contribute, and credit rating agencies can take or extend their role in providing a more systematic and comprehensive approach to their ratings of firms and loans. Section 3.1 of the Plan provides several useful action points in this respect, and several rating agencies already play a useful role here.
8. The disadvantage is that the 'S' and the 'G' become underattended. When it comes to long term investment, issues such as labour conditions, profit sharing, human rights, social and local community responsibility, transparency, anti-corruption initiatives, employee education, and many other ambitions, are relevant, too. This is clearly pointed out in sections 1.1 and 1.2 of the Action Plan, but less developed later on. In Annex 1 the Governance dimension is not even displayed.
9. Pension funds are by definition close to the 'S', because pensions are a labour condition. Especially DB plans can be considered a members' covenant, which is close to the workplace. Some pension funds do already select their investments on the basis of S and/or G metrics[4], for instance on the basis of the Global Compact[5]. The OPSG supports EIOPA's work to collect good practices in this respect. Insights can be gained from clearly distinguishing 'Social' from 'Governance', although causal relations may exist between the two[6], such as with employee representation and co-determination. Pension funds can engage and even exert active shareholdership so as to improve on the 'G' per se. Practice results suggest that better governance goes together with better returns, although the OPSG is not aware of an academic study which clearly proves this.
10. Again, the rating agencies can play a role, since they can already provide the ESG exposure of investment portfolios, i.e. in all three dimensions. Some rating agencies are already playing an increasingly important role, as ESG issues are already included in their rating evaluations of bond issuing companies. Also some large investment funds have developed good practices in

[3] There are exceptions, such as rated large multinational corporates and French institutional investors who do also take S and G factors in due consideration, since many decades already. If issuers take E, S, and G seriously, more 'green' investment projects become available. Therefore, one can argue that the focus should be on the issuers' side, not on the investors side. See for examples on French institutional investors e.g. FRR : http://www.fondsdereserve.fr/en/socially-responsible-investment ;ERAFP : https://www.rafp.fr/en/article/sri-erafp ;PERCO : https://www.lesechos.fr/25/03/2016/LesEchos/22158-164-ECH_l-isr-gagne-du-terrain-par-la-voie-privilegiee-de-l-epargne-salariale.htm and http://www.afg.asso.fr/en/key-figures/

[4] For example, the Dutch pension PWRI wants to foster inclusive hiring. Therefore, it overweighs in firms who hire employees with physical or psychological challenges. It also used the GreenHouseGas Protocol to calculate its CO2 footprint, and aims to lower this in the years to come. See https://www.pwri.nl/over-pwri/onze-eigen-accenten (in Dutch).

[5] In particular the Global Compact's principles on Labour:
Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4: the elimination of all forms of forced and compulsory labour;
Principle 5: the effective abolition of child labour; and
Principle 6: the elimination of discrimination in respect of employment and occupation.

[6] This causality is pointed out in footnote 9 of the Action Plan.

this respect[7]. Other parties have developed SDG[8] metrics by which they monitor their own impact[9].

11. The OPSG encourages the regulators (such as EIOPA) to strike the proper balance between the three dimensions of sustainability (E-S-G).

Taxonomy

12. The EC announces to develop a EU taxonomy, which *"will provide clarity on which activities can be considered 'sustainable'"*. The EC considers this action the most important and urgent action, as such taxonomy can guide investors and help monitoring the impact of investments. The EC plans to start working on a taxonomy with respect to climate, and proposes to develop other environmental dimensions as well as the social dimension at a later stage. The OPSG welcomes this pragmatic approach, but flags maintaining the momentum during the second stage. Since pensions are a labour condition, it makes sense to keep the social dimension of investments in focus for pension funds, from the social partners' perspectives.
13. The OPSG argues that any taxonomy has to be based on objective and scientifically proven facts, and not on subjective convictions, individual ethical opinions, or personal preferences of persons defining the taxonomy.
14. The EC wants to make a taxonomy applicable for retail investments as well. From the pensions perspective, this is relevant for DC plans, PRIIPs, and – if adopted – the PEPP. The OPSG welcomes this dual approach, and flags the risk of greenwashing in the retail market, where the demand side is unable to perform a thorough analysis of the investment propositions.

Specific asset classes

15. The EC quotes the OECD who state that infrastructure *"contributes to about 60% of greenhouse gas emissions"*. Therefore, the EC proposes to pool expertise and reinforce advisory capacity in order to support sustainable infrastructure investments.
16. Another asset class with obvious potential in this respect is real estate. Like infrastructure, real estate is long term by its sheer nature. The GRESB scores (Global Real Estate Sustainability Benchmark) facilitate monitoring and benchmarking of real estate projects, and are linked to the SDGs.
17. For pension investors, both asset classes are an obvious part of their investment mix, because they provide an illiquidity premium and some inflation indexation. Therefore, the OPSG welcomes the EC's action 3 on fostering investment in sustainable projects.

Plan members' preferences

18. Whether it be collective pension plans, in which boards of trustees have to act on behalf of the plan members, or investment firms who are to serve their clients, the fiduciary duty needs to be based on the preferences of future pensioners ('informed consent'). Therefore, these should be known. In section 2.4 the EC states that *"firms should ask about their clients' preferences (such as environmental, social and governance factors) and take them into account*

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[7] For instance, think of the Norwegian Government Pension Fund Global.
[8] The 17 Social Development Goals of the United Nations.
[9] For example, Triodos Bank provides information on their SDG impact in their annual report. See http://www.annual-report-triodos.com/en/2017/?osc=AT-brandbox-Annual-Report (in English).

when assessing the range of financial instruments and insurance products to be recommended, i.e. in the product selection process and suitability assessment". The OPSG understands this call for alignment[10], but also notes the complexity of such queries. Academic research into gauging risk preferences learns that it is very difficult to find this out in such way that the investment mix can be determined. In general there is a trade off between the degree of exactness of determining preferences, and the degree to which plan members understand the questions that are posed to them. This holds even more in situations where financial literacy is low in general, as is the case in several member states. In practice it may also be the case that most of the plan members just don't care about the environment, as seems to be the case in some member states. In fact, they may as well only care about the sustainability of the real value of their future income streams.

19. A fundamental difficulty with asking people's preferences, is that research is inconclusive in the existence of a trade-off between sustainability[11] and returns. Some research states that sustainable investment reduces the investment universe, and thereby never leads to higher returns. Instead, it leads to higher risk, due to a lower degree of diversification. Other research reveals that sustainable investments have lower risk (also through the cycle), and higher returns when corrected for risk. As long as the exact trade off (if any) of sustainability versus returns is unknown, it is hard to provide plan members with options to choose from, so as to gauge their preferences. Therefore, the OPSG wants to sign caution to the EC before this becomes mandatory. In the meantime, pension funds' boards of trustees may find other ways to align their investment decisions with the preferences of their plan members[12]. If plan members don't care about the environment, as was indicated above, then the board of trustees is faced with a difficult dilemma. What is the 'legal duties' pecking order'? In other words: is the fiduciary role more important than are universal values of sustainability? Unfortunately, the Action Plan does not take this dilemma into consideration. In any case it must be ensured, that actions taken to find out the preferences of beneficiaries in this regard may not result in inadequate additional cost burdens for the IORPs (which in most cases have to be carried by the beneficiaries themselves).
20. The difference between IORPs that manage DB plans and those that manage DC plans may also be of relevance. If a beneficiary has no or little choice in investment options there should be transparency on the ESG credentials of the collective investment policy. However in a DC IORP with investment choice for the beneficiary, they may be able to select investments based on their personal preferences themselves.
21. At the same time, the fiduciary role of the boards of pension funds should be made more explicit when it comes to ESG investments. The EU taxonomy could be used to improve transparency on the impact of investments, so that plan members can question their boards on the investment decisions that were taken on their behalf. In other words, action 7 on clarifying the fiduciary duties of institutional investors and asset managers can be complemented with transparency requirements for pension funds. Thus, comparing and benchmarking becomes easier, which also facilitates the discussion with pension plan

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[10] The consultation of beneficiaries is also advised by the EU High Level Expert Group on Sustainable Finance, in their Final Report 2018, p. 75.

[11] See footnote 1.

[12] E.g. the Cambridge Institute for Sustainability Leadership aims to pool investment expertise in this respect via its Investment Leaders Group. See https://www.cisl.cam.ac.uk/business-action/sustainable-finance/investment-leaders-group Other initiatives are the Focussing Capital on the Long Term (www.fclt.org) network, and the newsroom Shift to Long Term Investing (www.shiftto.org).

members. This is both relevant in situations where boards of trustees seem to care less about sustainability than their plan members, and in the opposite situation[13].

22. The Action Plan does not digress on pension funds with a diverse population in terms of ESG preferences. In such situation, gauging the preferences may be a challenge, but acting upon them is very hard to do, especially in DB plans. Moreover, in such situations the operationalization of the accountability is likely to be difficult. In DC plans, this may be easier, as individual plan members can choose their mix of investment funds[14], who can report on the implementation of their mandates.

Capital requirements

23. Action 8 states that EIOPA will be invited *"to provide an opinion on the impact of prudential rules for insurance companies on sustainable investments"*. In general, solvency requirements can be tailored in two ways: higher requirements for unsustainable ('brown') asset classes, or lower requirements for sustainable ('green') ones[15].
24. In an earlier OPSG meeting, it was conjectured that that EIOPA may not favour either of these approaches. It may be considered too arbitrary to attach solvency capital requirements to asset classes on the basis of their ESG impact. EIOPA may then prefer that the proper incentives are provided via the tax instrument. However, it is not clear why this would be less arbitrary. Tax instruments are often the result from political processes, whereas the ESAs are supposed to be at some distance from politics. Therefore, they have the room to calibrate their solvency requirements on risk profiles of asset classes. Thus, a 'brown' surcharge or a 'green' reduction may be a mere operationalization of standard capital requirements.
25. A note of caution is the possible effect of a 'green bubble' that may emerge, if all institutional investors show herding behaviour by investing in the same asset classes. While institutional investors have the ability and interest to invest in green assets, they may only do so if it makes sense from an ALM/return perspective. Therefore, prudential rules should not create artificial incentives/disincentives, but rather measure real risks. Hence, a lower capital requirement is acceptable if there is proof that a given 'green' asset is less risky than a 'brown' one.

Disclosure and accounting

26. In section 4.1 the EC announces actions to enhance sustainability disclosing and accounting. The OPSG welcomes such initiatives insofar as they contribute to transparency.
27. In general, the differences in reporting requirements for pension funds and insurance firms should be taken into account when relevant.
28. Moreover, the incentives of disclosure and accounting rules whould be such as to promote the long term orientation which characterizes both sustainable investments and (most) pension funds.

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[13] Some investment professionals warn for the 'financial repression' the Action Plan entails, and the expected lower saving and investment that may follow from such financial repression (see e.g. Investment & Pensions Europe, April 2018, p. 23).

[14] E.g. the National Employment Savings Trust (NEST) in the UK offers a 5 thematic funds: NEST Higher Risk Fund,
NEST Ethical Fund, NEST Sharia Fund, NEST Lower Growth Fund, and NEST Pre-retirement Fund.

[15] See for instance such proposal on page 11 of the white paper 'New Pathways: building blocks for a sustainable finance future for Europe' by i.a. the Global Alliance for Banking on Values (GABV).

Long termism

29. The time horizon of investments is often driven by incentives. The EC recognizes this in their action 10 which are directed towards the boards of corporates. At the same time, ESMA is invited to monitor undue short termism in capital markets.
30. Pension funds face a double challenge here. On the one hand, they are requested to aim for high return, even at the sacrifice of other long term goals. On the other hand, they have a long term perspective by their nature[16], which allows them to balance out high and low returns over time, and thereby invest in real development and growth. In this respect, they are not unique as other institutional investors face similar challenges. Some countries adopted stewardship codes so as to help trustees strike the proper balance[17].
31. In order to get these incentives aligned, it is important that pension funds' boards of trustees are evaluated on the basis of their long term results. Therefore, plan members have to be aware of the choices they face (if any). Accountability is key here, but poses extra challenges when it comes to plan member communication, and financial literacy in general.
32. Pension funds and other institutional investors can enhance their internal alignment by promoting their ESG champions to board level status.

Stress testing

33. As the EC Action Plan sets out, all three ESG factors can be considered as a risk when not taken into account timely and proportionally. For environmental risk, the translation into investment decisions is straightforward via so-called stranded assets. Such assets may face a steep decline in value once their environmental risks are taken into account. From a prudential point of view, both the NSAs and the ESAs warn against this risk[18]. They also flag the systemic character of the risk, as this entails entire asset classes and sectors.
34. The OPSG understands that ESG risks are to be part of stress tests. There are multiple ways in which ESG stress can affect pension funds, from valuation of the investment portfolio through opportunity losses, to reputation risks, and their license to operate. The OPSG prefers such stress tests to have a constructive character, i.e. focussing on risks that can be prevented or managed by pension investors, and which can be described by objective criteria (see remark above, under 'Taxonomy').

[16] The length of their time horizon depends on the ages of the plan members they serve, and on the open versus closed plan they manage.
[17] For a worldwide overview, see https://www.icgn.org/policy/stewardship-codes
[18] See for instance the recent Joint Committee of ESAs report on the risks and vulnerabilities in de EU financial system via https://esas-joint-committee.europa.eu/Pages/News/EU-financial-regulators-warn-against-risks-for-EU-financial-markets%2c-Brexit%2c-asset-repricing-and-cyber-attacks-key-risks.aspx which contains the following warning: *"The ESAs recommend financial institutions to consider sustainability risk in their governance and risk management frameworks and to develop responsible, sustainable financial products – moreover, supervisors should enhance their analysis of potential risks related to climate change for the financial sector and financial stability"*.

Other remarks

35. ESG investment needs alignment of interests. In the investment industry, work has to be done in order to have all contracts geared towards sustainable investment. Standardisation of ESG clauses can be helpful. The OPSG invites EIOPA and ESMA to join forces in this respect, and help the institutional investors in gearing their contract in the right direction.
36. In general, the OPSG considers the work on the taxonomy essential to any progress towards sustainable finance and investment, and the understanding of its impact. Such taxonomy can contribute to the accountability and transparency of pension plans, fund managers, and the distributors of investment funds.