Revision of IOPS Principles – Draft proposal for guidelines on the application of ESG factors in supervision of pension fund investment and risk management

INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS

IOPS Secretariat

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1. Background

- Membership agreed at the Berlin meeting on 29 October 2015 on the need to revise the IOPS Principles (previously updated in 2010).
- Project team: leader (tbc), CAPSA, China, Romania, Turkey.
- Other Members are strongly invited to join the project team

The project started in the second half of 2016; followed by

- the discussion on the first outline in Jamaica (Feb 2017), followed by written comments…

1. Background

- … the presentation and discussion (Paris, Jun 2017) of:
  - o changes to Principles (editorial; update with IOPS Good Practices for Governance of Pension Supervisory Authorities and outcomes of the Role of supervision in consumer protection in private pension systems)
  - o proposed areas for developing IOPS Guidelines (good practices, effective approaches) on:
    - Selected issues in pension funds investment governance
    - Supervision of innovative technological developments in private pensions
    - Supervision of cross-border activities
    - Financing of pension supervisory authorities

2. Proposal for Guidelines on ESG

- Room Document 1 presents a draft proposal for Guidelines on the application of ESG factors in supervision of pension fund investment and risk management.

- This document contains a set of draft guidelines on the integration (i.e. interpretation, role and use) of ESG factors in the area of supervision of pension fund investment and risk management.

3. Why ESG? (Background Note, pages 1-2)

- Recent developments such as Paris Agreement, the UN PRI (Principles for Responsible Investment), the Task Force on Climate-related Financial Disclosures, or new IORP II Directive. New issues emerging:
    - Integration of ESG factors in investment and risk management process?
    - Disclosure requirements of climate-related information (including carbon footprints) when institutional investors engage with the companies?
- Most recently, the Central Banks and Supervisors Network for Greening the Financial System was established "to better understand and manage the financial risks and opportunity of climate change.
- **IOPS needs to be ready to guide supervisors in this area.**

3. Why ESG? – cont.

- Practice observed in some jurisdictions: In their investment analysis process pension funds (like other institutional investors) take more and more often into account environmental, social and governance (ESG) risks and opportunities in their investments due to possible depreciation of assets in the future caused by changes in regulations and/or asset allocation by institutional investors.

4. Some working definitions

- *Environmental, Social and Governance (ESG) factors*: "indicators used to analyse a(investee) company's prospects based on measures of its performance on environmental, social, ethical and corporate governance criteria. (OECD, 2017)

- *Financial factors:* those which may influence investment decisions (for example about disinvesting from a certain company) due to financial considerations (for example due to concerns about company's future legal litigations or loss in shares' value).

- *Non-financial factors:* those which also may influence investment decisions but such decisions are not motivated by financial reasons (for example a disinvestment from a company because of ethical considerations). Obviously, non-financial decisions still may have financial implications for the pension fund.

4. Some working definitions – cont.

Environmental risks relate to: *physical risks* (direct impact of climate change), *transition risks* (changes in policy, law, markets, technology, investor sentiment and prices), *liability risks* (legal/moral responsibility to cover financial losses caused by climate change-induced events).

Social risks: relate to working conditions, including slavery and child labour; local communities, including indigenous communities; conflicts; health and safety issues; employee relations and diversity.

Governance risks: relate to executive pay, bribery and corruption, political lobbying and donations, board diversity and structure, tax strategy, etc.

NB: Technological innovations, including digital changes can, beside opportunities, create some social and operational risks.

5. The Guidelines

- Voluntary in nature → the word “should” is to be interpreted as an encouragement to supervisory authority to voluntarily adopt and implement them.

- The subject matter is relatively new and dynamically evolving → critical for the IOPS to bring the views and experience of the Members on how the ESG factors should be considered and integrated in the supervision of investment and risk management of pension funds.

- The aim is to gather these experiences and help supervisors respond to possible further regulatory developments in this area.

5. The Guidelines – cont.

- The implementation may vary from jurisdiction to jurisdiction depending on the structure of private pension system; should also take into account the principle of proportionality, i.e. the scale of the pension funds and complexity of its governing structure

- The guidelines are intended to apply to funded private pension funds or plans where assets are being invested in capital markets during accumulation and decumulation phases (regardless of whether voluntary, mandatory, or serve as the primary or supplementary source of retirement income).

6. Section I. ESG factors in the investment process

- 1.1. Supervisory authorities should require that a pension fund governing body consider all substantial financial factors, including environmental, social and governance factors (ESG) that may contribute to achieving the long-term retirement objectives of pension fund members and their beneficiaries. In particular, such wider interpretation should be taken into account in pension fund's investment and risk management process.

- 1.2. Supervisory authorities should clarify to pension fund governing body, trustees or asset managers that the explicit integration of ESG factors into pension fund investment and risk management process is in line with their fiduciary duties.

6. Section I. ESG factors in the investment process… – cont.

- 1.3. When offering a default investment arrangement, the pension fund's investment policy statement should include an explanation on how ESG factors are taken into account.

- 1.4. On the other side, pension funds should refrain from investing solely on ethical or ESG grounds unless pros and cons of such investment strategy can be quantified in financial terms and are agreed by members.

7. Section II. Integration and disclosure of substantial financial factors in the investment and risk management process

[Potentially to be split into II. Integration and III. Reporting and disclosure sections – Members views are solicited]

- 1.5. Supervisory authorities should require that governing body, trustees, or asset managers involved in development and implementation of pension funds' investment policy will integrate all substantial financial factors, including ESG factors, into their investment strategies (analysis and decision-making process) and will report how they integrate ESG factors in their investment and risk management process or provide explanations to pension supervisory authority should such factors are not integrated. Integration of ESG factors should be subject to the principle of proportionality, i.e. the scale of the pension funds and complexity of its governing structure.

7. Section II. Integration and disclosure of substantial financial factors in the investment and risk management process – cont.

- 1.6. Supervisory authorities should issue guidelines on how pension fund's governing body, trustees, or asset managers while setting up their investment policy should analyse substantial financial factors, including ESG factors. These guidelines would be based on a common IOPS international guidance note. The guidelines should address the necessary elements of the investment policy statement such as investment objectives in terms of return and risk, due diligence of the selection of investments, investment performance measurement and reporting, liquidity management and disclosure policies.

7. Section II. Integration and disclosure of substantial financial factors in the investment and risk management process – cont.

- 1.7. Supervisory authorities should require that, in their investment policy statements, governing body, trustees or asset managers of a pension fund disclose to its members information about pension fund investment policies in relation to long-term sustainability, including ESG factors, stewardship and non-financial factors. Pension funds should also regularly provide reports on their engagement with investees as well as request companies in which they invest to disclosure their ESG-related policies.

8. Section III. Other issues

[For potential inclusion, to be further developed – Members views are solicited]

- 1.8. Supervisory authorities should require that governing body, trustees or asset managers of a pension fund will develop appropriate stress test of investment strategy, prior to implementation. Such stress test should consider all substantial factors, including ESG factors. The scope and complexity of stress tests should be subject to the principle of proportionality.

Questions to Delegates

- What are your views on the current text of guidelines and annotations? How to develop them any further?
- Should there be any new sections that relate to new areas?
- Should we split Section II it into two different ones: ii) Integration and iii) Reporting & disclosure?)
- Can you offer your experience with regard to integration of ESG factors by pension governing bodies in your jurisdiction in their investment and risk management process? (footnote 28, page 5).
- Any other views & comments?

Thank you!

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