IOPS Draft guidelines on application of ESG factors in supervision of pension fund investment and risk management

IOPS Secretariat

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1. Background

- First 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 were presented at IOPS meeting in Dublin, Ireland on 22 February 2018
- This is the second draft intended for discussion. It has been developed on the basis of comments received during and after the IOPS meeting in Dublin on 22 February 2018. We are very grateful for your valuable feedback.
- Members will be kindly invited to provide their further written comments by 29 June 2018.
- The next draft will be presented at IOPS Technical Committee meeting in Beijing, China on 24 October 2018 after a possible further round of written comments.

2. 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.

2. 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 pay-out phases (regardless of whether voluntary, mandatory, or serve as the primary or supplementary source of retirement income).

3. 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. Section Background Note

- Par. 3 – Please provide further examples of jurisdictions where ESG issues are addressed in legislation]
- Par. 9 - ESG definition to be refined and possibly be illustrated by examples
- Par. 11 – Suggestion to explain governance risks better

4. 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~~ considerations should be taken into account in pension fund's investment and risk management process.*

4. Section I. ESG factors in the investment 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~~ does not on its own automatically conflict with their fiduciary duties.*

- Par. 15 (*relating to 1.2*) literature references to be provided on the positive effect of the improved governance

- Par. 15 (*relating to 1.2)* request to Members for country experience with regard to integration of ESG factors by pension governing bodies in your jurisdiction in their investment and risk management process

4. Section I. ESG factors in the investment process

(no changes made)

- *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.*

4. Section I. ESG factors in the investment process

- *1.4. The overall risk/return objectives (i.e. financial considerations) need to be met while setting and implementing an investment. Therefore~~, On the other side, p~~pension funds should refrain from investing solely on non-financial (e.g. ethical) grounds ~~or ESG grounds~~ unless pros and cons of such investment strategy can be quantified in financial terms and ~~are agreed by members~~.*

Current version:

1.4. The overall risk/return objectives (i.e. financial considerations) need to be met while setting and implementing an investment. Therefore, pension funds should refrain from investing solely on non-financial (e.g. ethical) grounds unless pros and cons of such investment strategy can be quantified in financial terms.

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

- *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~~ may be subject to the principle of proportionality, i.e. the scale of the pension funds and complexity of its governing structure.*

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

- Par. 19 *(relating to 1.5) Supervisory authorities should expect that pension funds will report on their awareness of ESG-related risks, estimated exposure to these risks, and methods they incorporate ESG factors in their investment and risk management process. In particular, pension funds may wish to present their plans for the transition towards low carbon economy and the ways they manage risks related to changes to market sentiment, new financial or environmental regulations or the emergence of new technologies. ~~In case pension funds do not integrate ESG factors, they should provide explanation for reasons of not doing so.~~ A possible form of reporting of the integration of the ESG factors in the investment and risk management process can be the provision of the investment policy and the risk management rules to the supervisory authority. [Members views are sought on forms of reporting, e.g. publication of information, provision to supervisor or both?] Based upon the information received from supervised entities, supervisory authorities may consider developing a heat-map of potential ESG-related risks, including climate change, in its pension industry and/or identify entities with the best practices.*

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

- *1.6 Supervisory authorities should issue a regulation or 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 instruments ~~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.~~*

Current version:

1.6 Supervisory authorities should issue a regulation or 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 instruments would be based on a common IOPS international guidance note.

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

- Par. 20. *(relating to 1.6.) Supervisory authorities should issue guidelines to pension fund stakeholders on how governing body should accommodate or integrate in their investment policy factors that are financially material to the performance of an investment, including ESG factors, as well as any other issues that are financially significant . Such guidelines will be developed by the IOPS. Supervisory authorities should ensure that pension fund managing body, trustees and asset managers analyse these factors in terms of implications for pension funds members and beneficiaries. Supervisory authorities may allow ~~for~~ fund managers/providers to offer pension fund members investment options which integrate ~~integration of~~ non-financial factors (e.g. ethical considerations) in the investment and risk management process, ~~emphasising~~ provided that such options do not exceed prudent limits and do not ~~there should a support for such decision from the pension fund members and that the factors should~~ pose ~~no~~ a risk of significant financial detriment to pension savings of members and their beneficiaries.*

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

Current version (previous slide)

- Par. 20. *(relating to 1.6.) Supervisory authorities should issue guidelines to pension fund stakeholders on how governing body should accommodate or integrate in their investment policy factors that are financially material to the performance of an investment, including ESG factors, as well as any other issues that are financially significant . Such guidelines will be developed by the IOPS. Supervisory authorities should ensure that pension fund managing body, trustees and asset managers analyse these factors in terms of implications for pension funds members and beneficiaries. Supervisory authorities may allow managers/providers to offer pension fund members investment options which integrate non-financial factors (e.g. ethical considerations) in the investment and risk management process, provided that such options do not exceed prudent limits and do not pose a risk of significant financial detriment to pension savings of members and their beneficiaries.*

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

Minor language clarification

- *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 disclos~~ur~~e their ESG-related policies.*

4. Section III. Other issues

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

- Par. 24 *(relating to 1.8.) Governing body of a pension funds, trustees or asset managers should determine appropriate ~~stress tests~~ scenarios tests for each investment strategy. Scenario-based thinking about risks should support risk management. Such ~~stress test~~ scenarios should cover a range of factors, including ESG factors (climate risk scenarios in particular) that can cause extraordinary losses or make the control of risk in the investment strategy difficult. Governing body of a pension fund, trustees or asset managers should use these scenarios to undertake ~~stress~~ scenario testing in order to confirm that the particular investment strategy is appropriate, prior to implementation. The principle of proportionality should apply.*

Thank you!

INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS