18 February 2016

**Re: Improving transparency and management of environmental, social and governance risks in the revision to the Institutions for Occupational Retirement Provision Directive (IORPs)**

Dear [Insert name of appropriate country attaché]

We the undersigned are writing in relation to revisions to the IORPs Directive (2014/0091 (COD)). We ask for your support for amendments recently passed by the European Parliament concerning transparency and consideration of environmental, social and governance factors in the investment process of pension funds.

The European Commission's proposal set out several key reasons why reform is required, including:

- '*higher governance standards reflecting best practices at national level following the economic and financial crisis are needed to protect scheme members and beneficiaries*'[i]
- '*to strengthen the capacity of IORPs to invest in assets with a long term economic profile and support the financing of sustainable growth in the real economy*'[ii]
- '*there is evidence of significant gaps in the level of information provided to scheme members and beneficiaries across Europe'*[iii]

The Commission proposal also specified that IORPs should carry out regular risk evaluations (Article 29) that should cover:

> *'29.2 (h) a qualitative assessment of new emerging risks relating to climate change, use of resources and the environment'*

Although the European Parliament ECON Committee draft report initially weakened provisions in these areas and deleted Article 29.2(h), we welcome the text passed by the Committee vote of 25th January 2016. This text strengthens the IORPs Directive in several key areas, namely consideration of environmental, social and governance factors in the investment process, transparency and information to be provided to (prospective) members and beneficiaries.

These revisions are crucial as IORPs in the EU hold assets worth over €3.2 trillion[iv] on behalf of 75 million Europeans[v]. There is growing recognition from investors and policymakers worldwide that environmental social and corporate governance (ESG) factors can be financially material, particularly for long-term investors like pension funds. For example, a recent meta-study of 2,250 academic studies into whether there is a link between ESG criteria and corporate financial performance found 'an overwhelming share of positive results'[vi]. Also, the rate of growth in the Sustainable and Responsible Investment Market is greater than the growth of the European Asset Management market overall.[vii] Therefore promoting the integration of ESG factors in investment decision making mitigates risks, builds resilience and stimulates new markets, products and services.

The good governance and risk management of IORPs is thus extremely important for the health of the EU economy and for the financial security in retirement of millions of citizens, particularly the increasing numbers with unguaranteed, 'defined contribution' pensions who bear investment risks themselves. As pension funds are a significant investor group in the global economy, they have the potential and duty to influence positively the behaviour of their investee companies on issues ranging from poor corporate governance, to human rights abuses in supply chains and emissions reductions.

A failure to properly consider ESG factors can put pension savers' money at risk. For example shareholders in Volkswagen have lost billions in the wake of the emissions and governance scandal which lead to a 32.36% drop in the automobile manufacturer's share price.[viii]

Taking the example of environmental risk, it is predicted that global warming of 6℃ could lead to losses of $13.8 trillion against the world's current $143 trillion stock of manageable assets; more than the entire market capitalisation of the London Stock Exchange.[ix] Even lower levels of global warming would cause highly unmanageable levels of systemic instability due to impacts on food and water security, risk of conflicts, ecosystems, health, infrastructure, extreme weather, and low lying countries and cities.[x]

The agreement at the COP 21 in Paris in December 2015 to limit global warming to below 2˚C will require 80% of all known fossil fuel reserves to remain in the ground, becoming 'stranded assets'.[xi] The stranded assets problem is highlighted as an urgent risk area by the World Bank,[xii] the Bank of England,[xiii] and the Financial Stability Board who have just created a task force on climate-related financial disclosures.[xiv] As fossil fuel reserves are an estimated 5% of total EU pension fund assets this is a serious risk for IORPs. [xv]

Furthermore, there is a growing view in the investment community that the transition to a low-carbon economy is a significant opportunity. For example the consultancy Mercer found in their recent report, '*Investing in a Time of Climate Change',* that a 2˚C global warming scenario could see return benefits for some asset classes including emerging market equities, infrastructure, real estate, timber and agriculture.[xvi] There is therefore an opportunity cost for pension savers if their schemes are overlooking this.

The European Systemic Risk Board has just warned that a late, abrupt transition to a low-carbon economy would be far more costly and risky than an orderly, gradual transition.[xvii] In this context the IORPs II Directive must enable and encourage pension funds to play a role in mitigating systemic risks and facilitating an orderly, managed transition to a low carbon economy.

Failure by pension funds to properly integrate ESG considerations into the investment process has impacts beyond climate change, ESG management within Europe and ordinary workers' savings. Research by Friends of the Earth groups has shown the link between some European Financiers (including some large pension funds) and companies responsible for land grabbing and deforestation in the palm oil sector for example.[xviii]

Although the integration of ESG considerations into investment decision making processes[xix] is improving, research into the largest IORPs in the UK[xx] and Netherlands[xxi] found that many are still failing to properly take these factors into account. There is good reason to believe that the situation is worse amongst smaller funds who 'find it more difficult to fully consider ESG issues due to lack of time, resources and in some cases understanding' according to one study.[xxii]

There is confusion amongst IORPs as to whether the 'prudent person principle', encompassing the 'duty to invest in beneficiaries' best interests', (Article 20.1 in this text) permits them to consider ESG factors. Several studies by the PRI,[xxiii] and the UK's Law Commission[xxiv] have found that investors and their legal advisors often interpret these duties, called fiduciary duties in some jurisdictions, as a duty to maximise short-term financial returns and exclude consideration of long-term and ESG factors. As such we believe that an IORPs II Directive which overly relies on the prudent person principle will not be effective at promoting long-term, sustainable investment.

Given the importance of IORPs behaviour for their members, the economy and a range of ESG issues related to their investment holdings, improved transparency of their investment practices and climate related risk disclosures is both necessary and overdue. We welcome the amendments passed by the Parliament's ECON Committee to Articles 29. 32, 40a(i), 55 and 58 which mandate transparency of IORPs annual accounts, risk assessment and Statement of Investment Principles to their members, beneficiaries and to the public.

The Common Position adopted by the Council on 17th September 2014 deleted Article 29.2(h) on environmental risks and did not contain any provisions to strengthen the Directive in relation to management of ESG investment risks or transparency. However, following the ECON Committee vote, we hope that your government will reconsider your position in relation to these issues. We have appended a list of amendments that we urge you to support to the end of this letter.

Yours sincerely,

ShareAction – the movement for Responsible Investment

actionaid

friends of the earth – see things differently

Friends of the Earth Europe

THE FINANCE INNOVATION LAB

urgewald

preventable surprises – Because the future matters. A lot.

global witness

ClientEarth

E3G

Frank Bold

CORE – PUTTING PEOPLE & THE PLANET AT THE CORE OF BUSINESS

WWF

**List of signatories**

ShareAction

ActionAid

Friends of the Earth England, Wales and Northern Ireland

Friends of the Earth Europe

The Finance Innovation Lab

Urgewald

Preventable Surprises

Global Witness

Client Earth

E3G

Frank Bold

CORE coalition

WWF

**List of amendments to support**

Recital 41

Article 5

Article 20(1)a, aa

Article 22(1)

Article 26

Article 29

Article 31

Article 32

Article 40a (5)i

Article 55

Article 58(1)

*Recital 41*

It is essential that institutions improve their risk management ***taking into account the objective of ensuring the intergenerational balance of the pension scheme,*** so that potential vulnerabilities in relation to the sustainability of the pension scheme can be properly understood and discussed with the competent authorities. Institutions should, as part of their risk management system, produce a risk ***assessment*** for their activities relating to pensions. That risk ***assessment*** should also be made available to the competent authorities ***and should include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')***. ▌

Article 5

Small pension institutions and statutory schemes

With the exception of Articles ***20(1), (3)-(7)), 22(1-5), and*** 34 to 37, Member States may choose not to apply this Directive, in whole or in part, to any institution located in their territories which operates pension schemes which together have less than 100 members in total***, or where the total of the institution's technical provisions does not exceed EUR 25 million***. Subject to Article 2(2), such institutions shall nevertheless be given the right to apply this Directive on a voluntary basis. Article 12 may be applied only if all the other provisions of this Directive apply.

Member States may choose to apply Articles 1 to 8, Article 12, Article 20 and Articles 34 to 37 to institutions where occupational retirement provision is made under statute, pursuant to legislation, and is guaranteed by a public authority. Article 12 may be applied only if all the other provisions of this Directive apply.

*Article 20(1)a, aa*

Investment rules

1. Member States shall require institutions located in their territories to invest in accordance with the 'prudent person' rule and in particular in accordance with the following rules:

(a) the assets shall be invested in the best ***long-term*** interests of members and beneficiaries ***as a whole***. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;

***(aa) the 'prudent person' rule shall not prevent institutions from taking into account the potential long-term impact of investment decisions on environmental, social, governance or ethical factors;***

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Article 22(1)

General governance requirements

1. Member States shall require all institutions to have in place an effective system of governance which provides for sound and prudent management of their activities. That system shall include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. The system of governance shall be subject to regular internal review. ***The system of governance shall require environmental, social and governance factors related to investment assets to be considered in investment decisions, shall involve relevant stakeholders and shall be subject to regular internal review.***

Article 26

Risk management ▌

1. Member States shall require institutions***, in a manner that is appropriate to their size and internal organisation, as well as the nature, scale and complexity of their activities,*** to have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis ***to competent authorities*** the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.

That risk-management system shall be ***effective and*** well-integrated into the organisational structure and in the decision-making processes of the institution.

2. The risk-management system shall cover appropriately to their size, internal organisation and the nature, scope and complexity of their activities risks which can occur in the institutions or in undertakings to which tasks or activities have been outsourced at least in the following areas:

(a) underwriting and reserving;

(b) asset–liability management;

(c) investment, in particular derivatives***, securitisations*** and similar commitments;

(d) liquidity and concentration risk management;

(e) operational risk management;

(f) insurance and other risk-mitigation techniques.

***(fa) social and environmental risks relating to the investment portfolio and the management thereof***.

3. Where, in accordance with the conditions of the pension scheme, members and beneficiaries bear risks, the risk management system shall also consider those risks from the perspective of members and beneficiaries.

4. Institutions shall provide for a risk-management function structured in such a way as to facilitate the ***functioning*** of the risk-management system.

Article 29

***Own risk assessment***

1. ***As*** part of ***its*** risk-management system, ***and in a manner that is appropriate to its size and internal organisation, as well as to the nature, scale and complexity of its activities, every institution shall conduct its*** ▌own risk assessment ▌.

The risk ***assessment*** ▌ shall be performed regularly and without delay following any significant change in the risk profile of the institution or of the pension ***schemes operated by the institution***.

2. The risk ***assessment*** referred to in paragraph 1 shall cover***, where appropriate to the nature, scale and complexity of the institution's activities***:

(a) the effectiveness of the risk-management system;

(b) the overall funding needs of the institution;

(c) the ***risks inherent to the sufficiency of*** technical provisions ***in respect of the total range of pension schemes operated***;

▌

(e) ***the risks to members and beneficiaries relating to their entitlements being paid out and the effectiveness of any remedial action***;

(f) a qualitative assessment of ***any financial*** support***, including guarantees, pension protection schemes or covenants,*** accessible to the institution***, or to members and beneficiaries***;

(g) a qualitative assessment of the operational risks ▌,

(h) ***an*** assessment of new or emerging risks***, including risks related*** to climate change, use of resources and the environment***, social risks and risks related to the depreciation of assets due to regulatory change***.

3. For the purposes of paragraph 2, the institutions shall have in place methods to identify and ***assess*** the risks they are or could be exposed to in the short and in the long term. Those methods shall be proportionate to the nature, scale and complexity of the risks inherent in its activities. The methods shall be described in the ***assessment***.

4. The risk ***assessment referred to in paragraph 3*** shall ***take into account the objective of ensuring the intergenerational balance of the pension scheme, shall*** be ***performed regularly and form*** an integral part of the operational strategy and shall be taken into account in the strategic decisions of the institution. ***It shall be made available to the members of the scheme.***

▌

Article 31

Annual accounts and annual reports

Member States shall require every institution located in their territories to draw up ***and publicly disclose*** annual accounts and annual reports taking into account each pension scheme operated by the institution and, where applicable, annual accounts and annual reports for each pension scheme. The annual accounts and the annual reports shall give a true and fair view of the institution's assets, liabilities and financial position***, and include disclosure of major investment holdings***. The annual accounts and information in the reports shall be consistent, comprehensive, fairly presented and duly approved by authorised persons, in accordance with national law.

Article 32

Statement of investment policy principles

Member States shall ensure that every institution located in their territories prepares and, at least every three years, reviews a written statement of investment-policy principles. That statement is to be revised without delay after any significant change in the investment policy. Member States shall provide for this statement to contain, at least, such matters as the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities ***and how the investment policy takes environmental, social and governance issues into account. The statement shall be made publicly available on a website***.

***Article 40a (5)i***

***Pension benefit statement***

***[...]***

***5. Within the framework of this Directive, key relevant information for members shall include:***

***[...]***

***(i) where and how to obtain further information relating to the institution or pension scheme, including the information specified in Articles 31 and 32;***

*Article 55*

Information to be given to prospective members

***Member States*** shall ***require institutions to*** ensure that prospective members are informed***, before they join a pension scheme, about the relevant*** features of the

***pension*** scheme and any ▌options ***available to members,*** including information on how environmental, climate, social and corporate governance issues are considered in the investment approach.

***Where prospective members do not have a choice and are automatically enrolled in a pension scheme, the institution shall provide them with the key relevant information about their membership immediately after enrolment***.

Article 58(1)

Additional information to be given on request to members and beneficiaries

1. On request of a member, a beneficiary or their representatives, the ***institution*** shall provide the following additional information:

(a) the annual accounts and the annual reports referred to in Article 31, or where an institution is responsible for more than one scheme, those accounts and reports relating to their particular pension scheme;

(b) the statement of investment policy principles, referred to in Article 32

(c) ***any further*** information about the assumptions used to generate the projections referred to ***in*** Article ***40a(4)(d).***

[i] European Commission (2014), *Proposal for a Directive on the activities and supervision of institutions for occupational retirement provision, 2014/0091 (COD)*, paragraph 1
[ii] Ibid., paragraph 1
[iii] Ibid., paragraph 1
[iv] Pensions Europe (2014), *Statistical Survey 2014 – results, available at http://www.pensionseurope.eu/statistics*
[v] Hayes, B., *Working Document on the proposal for the Directive of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision (recast)*, Committee on Economic and Monetary Affairs, European Parliament
[vi] Friede, G., Lewis, M., Bassen, A. Busch, T., (2015), *ESG & Corporate Financial Performance: Mapping the global landscape,* Deutsche Asset & Wealth Management and the University of Hamburg, available at https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf
[vii] Eurosif (2014), *European SRI Study 2014,* available from http://www.eurosif.org/wp-content/uploads/2014/09/Eurosif-SRI-Study-20142.pdf
[viii] Financial Times, (14/02/2016), *Carmakers urged to clear the air on emissions lobbying*
[ix] Economist Intelligence Unit, (2015) *The cost of inaction: Recognising the value at risk from climate change*, available from http://www.economistinsights.com/sites/default/files/The%20cost%20of%20inaction.pdf
[x] Pidcock, R., (10/12/2014), *What happens if we overshoot the two degree target for limiting global warming?,* Carbon Brief, available at http://www.carbonbrief.org/what-happens-if-we-overshoot-the-two-degree-target-for-limiting-global-warming
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[xii] Speech by World Bank Group President Jim Yong Kim Press Conference at the World Economic Forum Davos, Switzerland, 23/01/2014, http://www.worldbank.org/en/news/speech/2014/01/23/world-bank-group-president-jim-yong-kim-remarks-at-davos-press-conference
[xiii] Letter from Bank of England Governor to Chair of Environmental Audit Committee of UK Parliament, 30/10/2014, http://www.parliament.uk/documents/commons-committees/environmental-audit/Letter-from-Mark-Carney-on-Stranded-Assets.pdf
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[xvi] Mercer (2015), *Investing in a Time of Climate Change*, available at http://www.mercer.com/insights/focus/invest-in-climate-change-study-2015.html
[xvii] ESRB Advisory Scientific Committee (02/2016), *Too late, too sudden: Transition to a low-carbon economy and systemic risk,* European Systemic Risk Board, available at https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf
[xviii] Friends of the Earth Europe, (2013) *Commodity Crimes: Illicit land grabs, illegal palm oil, and endangered orangutans,* available at https://www.foeeurope.org/Last-chance-financiers-palm-oil-companies-211113
[xix] Eurosif (2014), European SRI Study 2014, http://www.eurosif.org/wp-content/uploads/2014/09/Eurosif-SRI-Study-20142.pdf
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