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Institutions for Occupational Retirement Provision Directive

Dear Ms. Berger,

We the undersigned are writing with reference to the passage into law of the Institutions for Occupational Retirement Provision (IORP II) Directive. We were pleased that the legislation states that IORPs must take account of environmental, social and governance (ESG) factors in their investment decisions (we refer in particular to Articles 21, 25 and 30 of the Directive). This constitutes a significant contribution to the Capital Market Union (CMU) priority of supporting the development of a sustainable finance system. However, we feel greater clarity is needed on how ESG relates to the fiduciary duties of investors. We believe the Commission is well placed to issue guidance on this matter as a matter of urgency, drawing upon work already carried out within the Commission services.

The Directorate-General for the Environment's 2015 report, *Resource Efficiency and Fiduciary Duties of Investors* (the DG Environment report)[1] explored the extent to which financial risks associated with ESG factors are incorporated into investment strategies. The report found that despite most institutional investors claiming to apply sustainable and responsible investment strategies, the final impact on investment decisions is rarely disclosed and the actual investment decisions do not seem to result in widespread long-term sustainable investment behaviour. The report made a number of recommendations for addressing this issue, and we would like to know how the Commission is planning to take these forward, particularly in the context of the mid-term review of the CMU, which aims to increase the flow of capital to sustainable investments.

The two-year period for Member States to transpose the IORP II Directive is underway. This would form an important element in accelerating the implementation of the sustainability aspects of CMU.

The need for guidance

Article 19 of the IORP II Directive states as follows -

[1] DG Environment (2014). *Resource Efficiency and Fiduciary Duties of Investors: Final Report*. Available at: http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf [accessed 23.02.2017].

> *Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.*[2]

Firstly, we feel this clause does not make it clear that ESG factors can carry financial risks which may impact on investment returns. Secondly, it is not sufficiently clear, given the use of the phrase "shall allow", that IORPS should consider the financial impact of ESG factors on investments. However, articles 21, 25, 29 and 30 do specify that IORPs should consider ESG risks that can impact on their investments.

However, given the depth and persistence of confusion on this topic, and the detrimental effect this could have on savers' long-term outcomes and on the environment and human rights, we strongly recommend issuing guidance to dispel the misconceptions that remain.

The DG Environment report highlights confusion amongst investors on the extent to which their fiduciary duties allow them to consider ESG factors in investment decisions. A global survey mentioned in the report found 9 out of 10 investors recognise that, when there are ESG concerns associated with companies they invest in, it carries a financial risk. Despite this, ESG issues are not comprehensively factored into investment decision-making. For example, when reviewing their investment rules, only 30% of investors 'frequently consider' ESG concerns, with a further 32% saying they 'occasionally consider' them.[3]

A recent snapshot survey of the UK pensions industry by *Professional Pensions* gives further evidence of this confusion. Only 21% of respondents said that ESG factors were fully embedded in their investment approach and 39% said they do not take ESG factors into account and are not considering doing so. The survey asked what factors may prevent climate risk from being taken into account in investment decisions: 32% of respondents said trustee boards do not deem climate risk to be significant. A further 16% felt there was a lack of legal clarity on whether pension funds are permitted to take climate risk into account.[4]

These findings are of great concern. They suggest some investors believe their fiduciary duty – to act prudently, and in their members' interests – is actually compromised by taking account of ESG factors. However, there is increasing evidence showing that companies that perform well on environmental, social and governance (ESG) issues tend to produce better returns for investors, particularly over the long term.[5] This is particularly true of investors with long-term investment horizons, like many pension funds, as these factors are more likely to be financially material over longer time horizons. In addition, companies that do badly on ESG measures could face negative financial impacts via damage to reputation and/or legal proceedings. Incorporating ESG concerns makes for a robust, risk-adjusted investment strategy that will also benefit wider society and the environment.

Recommendations

The DG Environment report makes recommendations for clarifying this point. In particular we welcome its suggestion that:

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[2] Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs). Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016L2341 [accessed 23.02.2017].

[3] DG Environment (2014). *Resource Efficiency and Fiduciary Duties of Investors: Final Report*, p 49. Available at: http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf [accessed 23.02.2017]

[4] Professional Pensions (August 2016). "Climate change is 'overblown nonsense' and not a material risk, says industry". Available online at: http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry [accessed 23.02.2017].

[5] E.g. Arabesque Partners and University of Oxford (2015). From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance. Available at http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11 [accessed 23.02.2017].

> *National financial authorities with support from the European Commission provide official guidance and interpretation of fiduciary duties and the extent to which institutional investors may include ESG issues into their investment strategies and decisions.*[6]

The two-year period for Member States to transpose IORP II is underway. In light of this, it is essential that this guidance is published as soon as possible, so that Member States can transpose IORP II effectively and ensure that pension funds across the EU are clear about their duty to incorporate financially material ESG factors in their investment decisions.

The current two-year implementation period offers an immediate window of opportunity for the Commission to introduce guidance that would create uniform and smooth application of the ESG provisions across the EU. It should be made clear that asset managers and asset owners have a duty to consider ESG factors where they are likely to be financially material. This would provide necessary clarity for pension funds in making investment decisions.

Summary

We are keen to ensure that once IORP II is implemented across the EU, investment practices are changed for the better. Together with the supportive language on ESG in the Shareholder Rights Directive as agreed in the Trialogue discussions, the Directive's provisions on ESG have laid an important foundation on which to build a sustainable capital market. We believe the DG Environment report's recommendations should form the next steps in this work, and would be in the spirit of the horizontal approach across the DG's set out in the Commission membership of the High Level Expert Group on Sustainable Finance (HLEG). We do not believe that further analysis of this topic is needed, as there is a great body of evidence with which to take action now.[7]

In summary, we would request that the Commission issues guidance (a) clarifying that IORPs' fiduciary duties do not prevent them from considering ESG factors in investing; and (b) confirming that IORPs *should* consider financially material ESG factors. We would welcome the opportunity to discuss these issues in more detail.

Yours sincerely,

Ario Advisory

CDP

Climate Disclosure Standards Board

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[6] DG Environment (2014). *Resource Efficiency and Fiduciary Duties of Investors: Final Report*, p 10. Available at: http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf [accessed 23.02.2017]

7 See for example the Directorate-General's report, the UK Law Commission's 2014 report on fiduciary duty, the work of the UN Principles of Responsible Investment initiative (explicitly recognised as a source of expertise in IORP II rec 58, and observer in the HLEG), the US Department of Labor, Interpretive Bulletin (IB 2015-01) on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors, October 2015.

Ethos, Swiss Foundation for Sustainable Development

Frank Bold

Foundation Development YES - Open-Pit Mines NO (Fundacja „RT-ON")

Preventable Surprises

ShareAction

Smith School of Enterprise and the Environment, University of Oxford

SÜDWIND e.V. - Institut für Ökonomie und Ökumene

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