ESG INVESTMENT BY PENSION FUNDS

Selected policy issues

André Laboul, Chief Policy Advisor, IOPS

Presentation

- Selected policy issues
  - Context
  - Some policy responses
- Pension funds Supervisors: international position
- Conclusions

The context

- Higher policy recognition, but…
  - Most fora
  - Definition (plus link resilience sustainability)
  - Development issues(cfr also NGFS)
  - Political issues (EU)
  - Investment regulation but still not a lot ESG
- Higher investors recognition, but…
  - Investment risks
  - From nice to have to must have
  - Fiduciary duties
  - Return objectives
- Positive or neutral impact, but…
  - Positive or neutral
  - But recent studies
  - Costs issue

Possible Forms of Institutional Investor Regulation

	Form of limitation (mostly in percentage terms)	*Features which limits may differ by*
Instrument	Assets under management Technical provisions Absolute limit Duration limit Collateral or loan-to-value Asset value recognised	Type of pension or provider Asset class Credit rating Sub-fund Characteristic (liquid, risky, etc.) Funding level Phase (payout vs. accumulation)
Vehicle	Assets under management Instruments invested in	Type of pension Type of counterparty Sub-fund
Jurisdiction	Assets under management Unhedged currency exposure of assets	Geographical jurisdiction Exchange on which assets are traded Sub-fund Type of fund Asset class
Nature of transaction	Assets under management Assets of individual pensioner Collateral as a percentage of assets under management Duration limit Leverage limit Asset value recognised	Single issuer vs. group Asset class Market Geographic jurisdiction Exchange
Concentration	Assets with single counterparty Assets with single intermediary Assets per fund Assets in a single asset Anticipated value of assets invested in single asset Assets in a single sector Limit on sum of 'large' concentrations Assets per issue Absolute limit Percentage of total share of issuer Percentage of total bonds of issuer Percentage of total capital of issuer	Asset class Asset characteristic Credit rating Geographical jurisdiction of issuer Market of issuer Type of fund Single issuer vs. group Fund size

Risks With specific geographical features

Infrastructure projects face a wide variety of risks

The risk profile of projects evolves over the project lifecycle

Risk Categories	Development Phase	Construction Phase	Operation Phase	Termination Phase
Political and regulatory	Environmental review	Cancellation of permits	Change in tariff regulation	Contract duration
	Rise in pre-construction costs (longer permitting process)	Contract renegotiation		Decommission
				Asset transfer
			Currency convertibility	
	Change in taxation			
	Social acceptance			
	Change in regulatory or legal environment			
	Enforceability of contracts, collateral and security			
Macroeconomic and business	Prefunding	Default of counterparty		
	Financing availability		Refinancing risk	
			Liquidity	
			Volatility of demand/market risk	
	Inflation			
	Real interest rates			
	Exchange rate fluctuation			
Technical	Governance and management of the project			Termination value different from expected
	Environmental			
	Project feasibility	Construction delays and cost overruns	Qualitative deficit of the physical structure/ service	
	Archaeological			
	Technology and obsolescence			
	Force majeure			

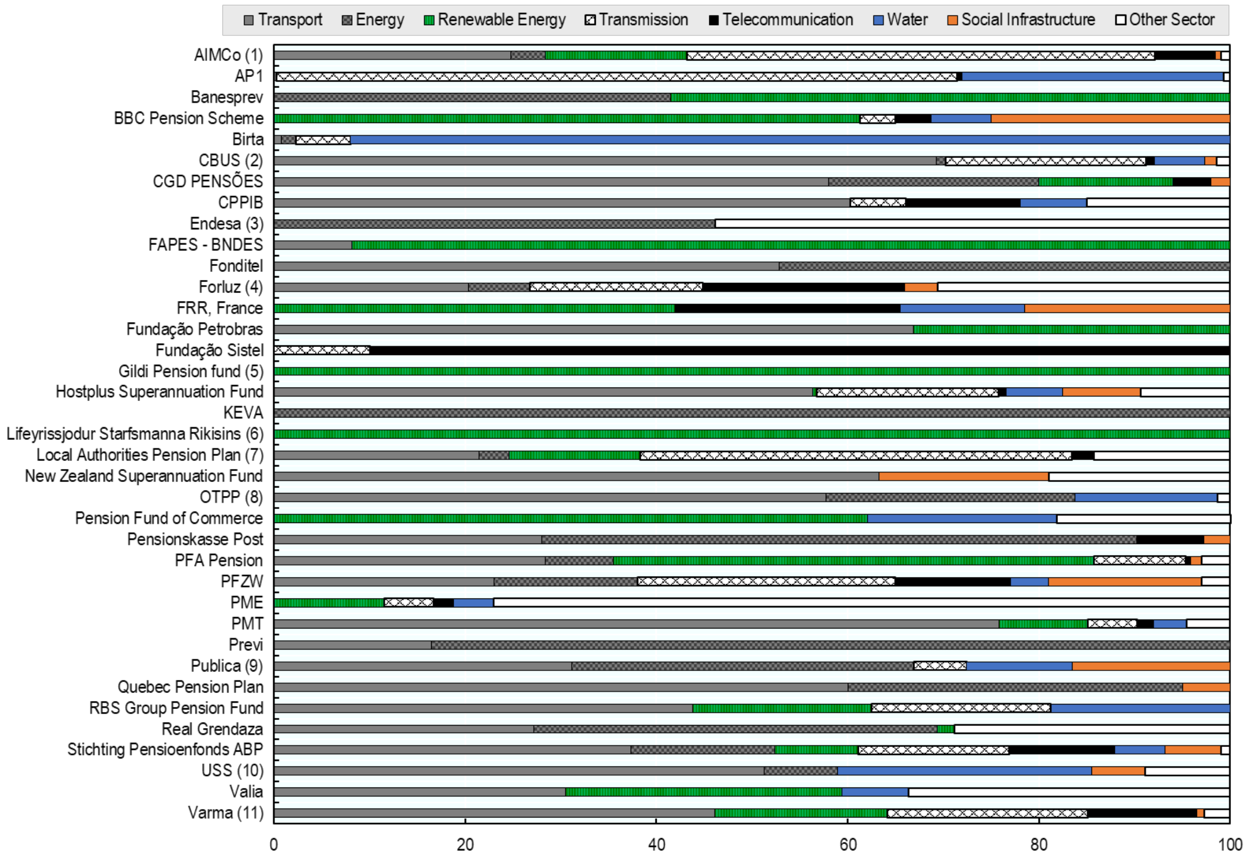
Source: OECD (2015), Infrastructure Financing Instruments and Incentives: a Taxonomy.

Certain risks represent a particular challenge for infrastructure investors in developing countries

The context

- The E the S and the G
  - Most is about E
  - But growing S: chldren, inclusiveness, gender, water/energy access
  - G: key governance and also corruption, bribery, legal certainty
- And many obstacles:
  - Policy
  - Fragmentation
  - Indices focus
  - stakeholders
  - Inconsistencies
  - Taxonomies
  - methodolologies

Evidence: Pension funds as significant investors in the energy transition



Source: OECD Annual Survey of LPF and PPRF

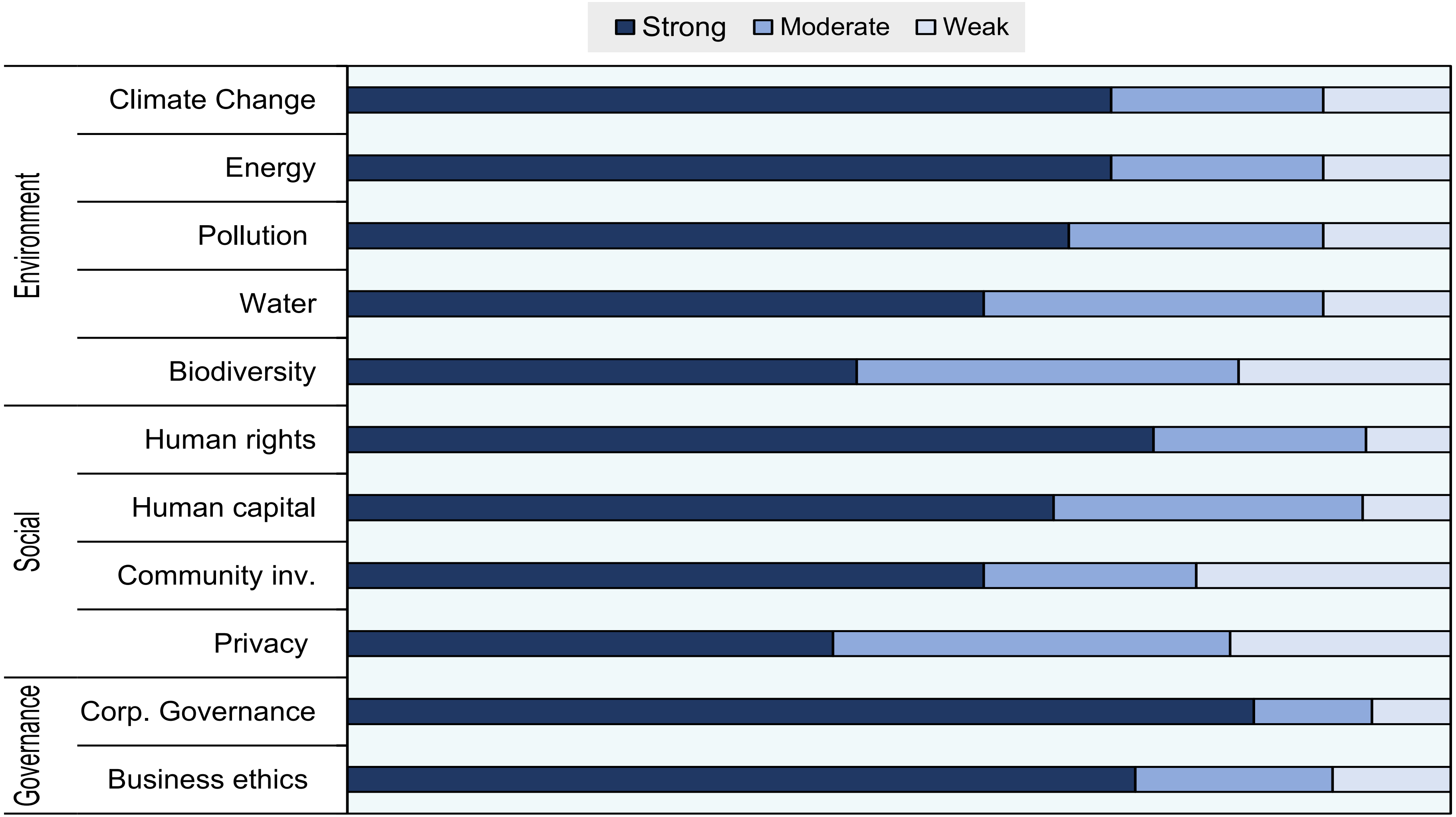
OECD data provides evidence that pension funds are significant investors in renewable energy and that they have actively been financing the energy transition.

Transportation and energy are the largest allocations amongst funds surveyed, indicating investor preference and availability of opportunities.

Renewable energy and social infrastructure are relatively new sectors in the portfolio of certain investors although increasing.

ESG aspects considered in infrastructure investments by pension funds

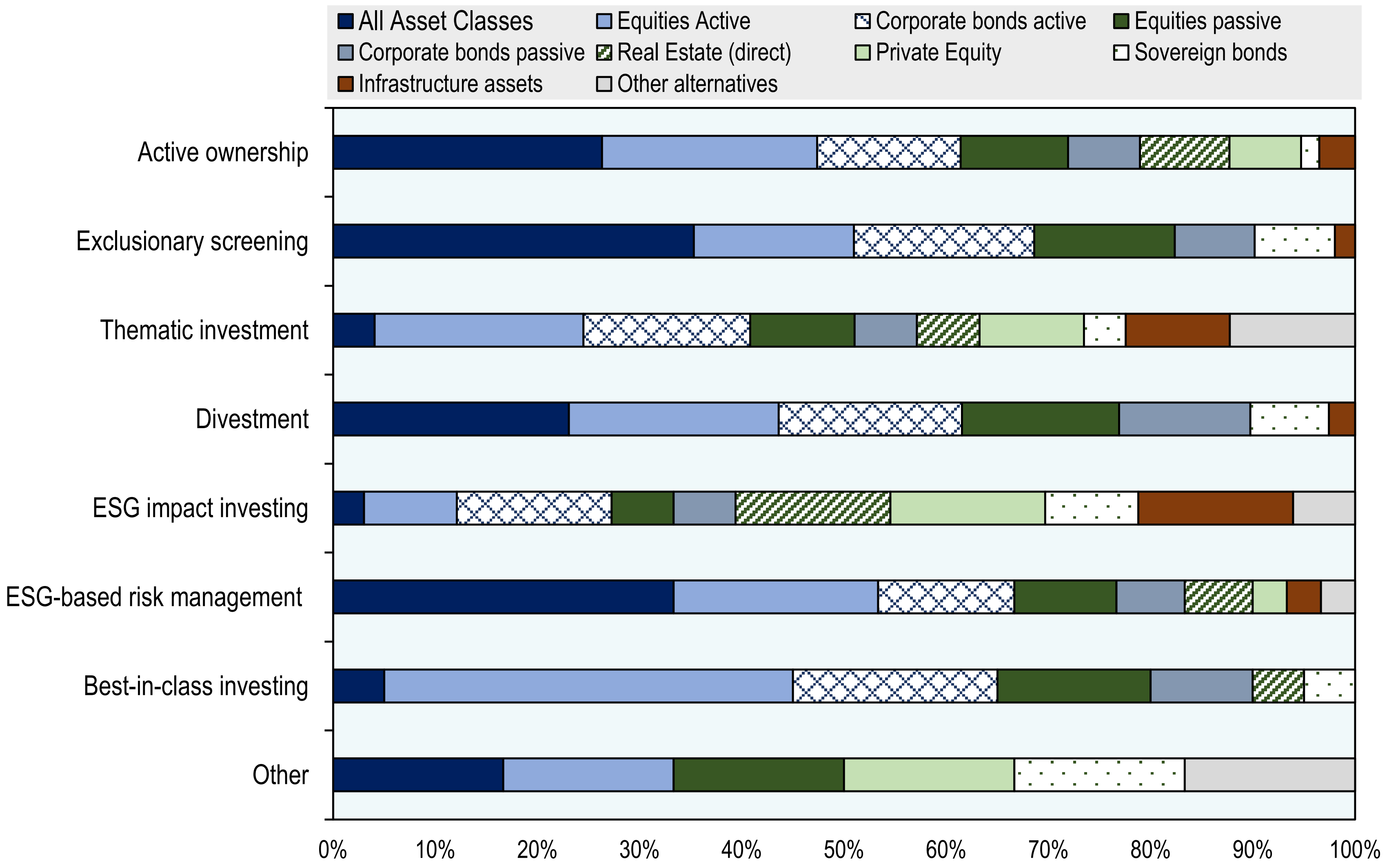
As a percentage of total respondents that indicated to consider the relevant ESG aspect (2020)



Pension funds’ ESG investment strategy

ESG investment strategies in asset classes, 2020

As a percentage of total pension funds that engage in the relevant strategy



Social

G20 Principles for Quality Infrastructure Investment, Principle 5:

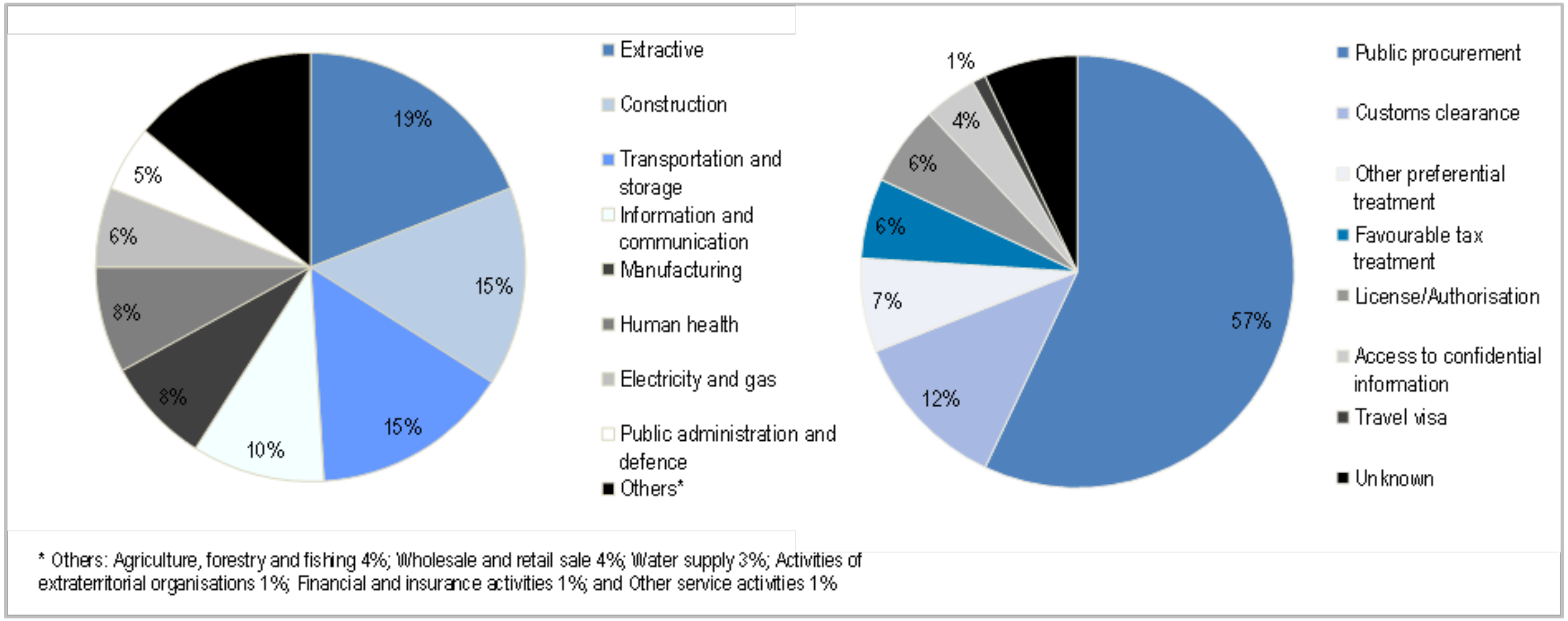
- **5.2 Practices of inclusiveness should be mainstreamed throughout the project life cycle.**

Design, delivery, and management of infrastructure should respect human rights and the needs of all people, especially those who may experience particular vulnerabilities, **including women**, children, displaced communities or individuals, those with disabilities, indigenous groups, and poor and marginalized populations.

- **5.3**. **All workers should have equal opportunity to access jobs created by infrastructure investments, develop skills, be able to work in safe and healthy conditions, be compensated and treated fairly, with dignity and without discrimination**.

Particular consideration should be given to how infrastructure facilitates **women's economic** empowerment through equal access to jobs, including well-paying jobs, and opportunities created by infrastructure investments. Women's rights should be respected in labor market participation and workplace requirements, including skills training and occupational safety and health policies.

Governance: Bribery



Issues for consideration

Taxonomy and classification

- Various terms are used in different ways across the industry → difficult to know what actions/decisions are associated with various terms, and implication for risks and returns.

Ratings comparability

- Ratings approaches and scores vary widely, and lack of transparency over detailed methodologies and judgment results in different ESG ratings, which can in turn influence index weights and portfolio tilting.

Performance & benchmarking

- Range of fund styles and index benchmarks makes it difficult to understand (a) performance on a relative basis, and (b) the extent to which goals other than financial risk-adjusted returns are pursued by the funds.

Promising developments → but need for policy engagement to ensure efficiency, transparency, and integrity.


Enhancing environmental and social outcomes and resilience
Embedding environmental and social considerations into investment and management practices
Enhancing and developing methods to finance quality infrastructure
Strengthening social sustainability and minimizing negative impacts
Promoting and enabling responsible business conduct to support quality infrastructure

Investment governance and the integration of environmental, social and governance factors selected issues (OECD)

- Regulatory frameworks provide scope for ESG integration but do not necessarily encourage it.
- Institutional investors interpret their responsibilities towards their members and beneficiaries in different ways.
- Policymakers should encourage new types of models that enable institutional investors to include ESG risks in stress tests and own risks and solvency requirements.
- Integration is hampered by the lack of commonly-accepted analytical methods and data.
- There is a considerable uncertainty about policy paths.
- While an increasing number of ESG investment options are available, investors face technical, operational and behavioral difficulties in selecting, implementing and measuring the effect of ESG strategies.

G20/OECD Report: Investor proposals

Investor proposals:

- 6.1 Encourage a common understanding of ESG criteria and infrastructure
- 6.2 Promote the ability of investors to measure and compare sustainability and ESG performance in infrastructure investment, through better infrastructure project data disclosure

A possible avenue for follow up on ESG infrastructure data for investors, as a response to investor proposals

- *Broad objective* :
  - Ensure availability of relevant, reliable, and transparent sources of data on infrastructure projects that describe ESG criteria, and adequate policies, methodologies, tools, and standards to process this data into useful information for ESG evaluation
    - Develop a better understanding of the ESG practices and needs of investors by gathering information and data on their ESG policies and goals for their infrastructure portfolios, and data issues / gaps
    - Review policies and treatment of ESG considerations in policy and regulatory regimes applicable to institutional investors
    - Better understand investor needs regarding ESG data and their methodologies, willingness of the market (asset and investor level) to disclose ESG data, and role of the market and policy to address issues

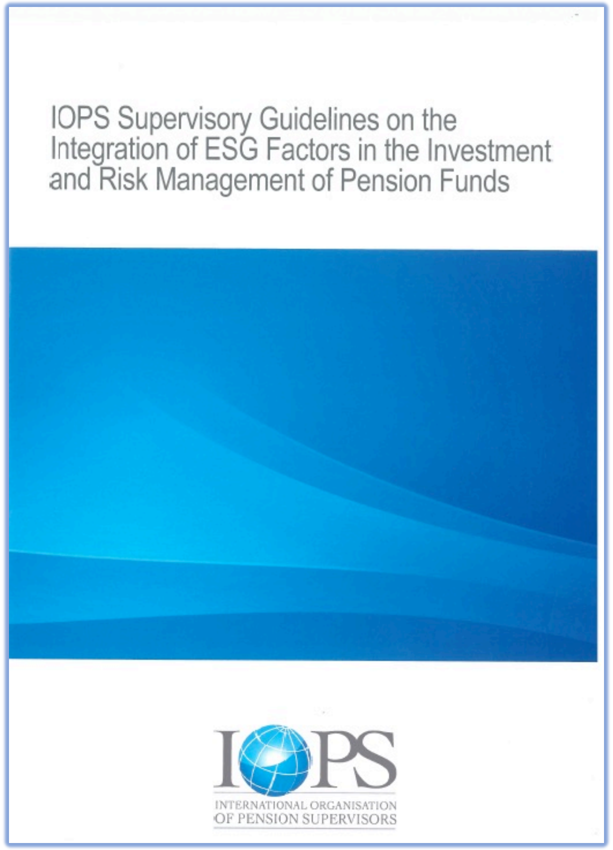
- Developing methodology to collect quantitative and qualitative data on financial , ESG and impact benchmarks
- Identify potential priority areas to focus efforts on ESG infrastructure data, identifying availability or ease of sourcing data
- Collecting first qualitative information from investors on decision making process in investing in ESG infrastructure : past current and expected future strategies, obstacles, policy proposals
- Complementing this collection with qualitative information from governments, regulators/supervisors on their strategies related to the promotion of ESG in infrastructure investment decision making by asset owners and managers

IOPS work on pension funds

- In October 2019, the International Organisation of Pensions Supervisors (IOPS), ie the *Pension funds supervisory standard setters,* released the

"***IOPS Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds***".

And decided in November 2020 to develop related implemention tools



Context

- Increased pension funds investment in ESG areas (risks and opportunities)
- Still new, dynamic, lot of uncertainties
- Lack of data for PF and for supervisors
- New supervisory guidelines but !! Do not intend to induce PF into ESG investments
- Flexibility, proportionality
- ESG factors are hybrid but considered as financial for the guidelines
- Implementation guidance

IOPS guidelines

Guideline 1: Supervisory authorities should require that a pension fund governing body consider environmental, social and governance (ESG) factors, along with all other substantial financial factors,

- *importance understanding, right governance, data, communication strategies*

Guideline 2: Supervisory authorities should clarify to a pension fund governing body or the asset managers that the explicit integration of ESG factors into pension fund investment and risk management process is in line with their fiduciary duties.

IOPS guidelines

Guideline 3: Information on sacrificing returns

- ➢ *communication on significant sacrifice*

Guideline 4: no prejudice for the objective of obtaining an appropriate risk-return profile on purely financial grounds.

IOPS guidelines

Guideline 5: Supervisory authorities should require that a governing body and the asset managers integrate ESG factors, along with all substantial financial factors, into their investment strategies (analysis and decision-making process).

- Supervisory authorities should avoid being overly prescriptive on how governing bodies should deal with ESG factors
- Supervisory authorities should also request that in case these factors are not integrated in investment and risk management process, a governing body and the asset managers provide explanations.
- Integration of ESG factors may be subject to the principle of proportionality, i.e. the scale of the pension funds and complexity of its governing structure

Guideline 6: regulation on how to analyse ESG factors

IOPS guidelines

Guideline 7: Supervisory authorities should require that a governing body or the asset managers involved in the development and implementation of the pension fund's investment policy will report to supervisory authorities how they integrate ESG factors in their investment and risk management process.

Guideline 8: regulation on how to report on substantial financial factors, including ESG factors

Guideline 9: Supervisory authorities should require that, in their investment policy statement, a governing body or the asset managers of a pension fund disclose to its members and stakeholders information about the pension funds' investment policies in relation to long-term sustainability, including ESG factors, stewardship and non-financial factors.

IOPS guidelines

(guideline 9 follow) Where appropriate, pension funds should also regularly provide reports on their engagement with investees as well as request companies in which they invest to disclose their ESG-related policies

Guideline 10: Supervisory authorities should encourage a governing body or the asset managers of a pension fund to develop appropriate scenario testing of its investment strategy. Such 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

Selected concluding comments

- Major trends
- Major issues
- Complex issue which call for careful consideration
- Urgent need for international action
- Major issue for Pension funds which have very special characteritics
- Further work by pension funds supervisors ongoing